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Erik M. Jensen

Case Western University School of Law, emj@case.edu

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ARTICLES

THE SUPREME COURT AND THE TIMING OF DEDUCTIONS FOR ACCRUAL-BASIS TAXPAYERS

Erik M. Jensen*

In June 1986 and April 1987, the United States Supreme Court decided *United States v. Hughes Properties, Inc.*¹ and *United States v. General Dynamics Corp.*,² respectively, cases dealing with the timing of deductions by accrual-basis taxpayers. The time value of money dominates the current theoretical tax literature,³ and timing is an

* Associate Professor of Law, Case Western Reserve University School of Law. S.B. (1967), Massachusetts Institute of Technology; M.A. (1972), University of Chicago; J.D. (1979), Cornell Law School. The author expresses his appreciation to Professor Peter D. Junger and Helen B. Jensen, Esq., both of whom commented on earlier versions of the manuscript. Remaining errors and infelicities are in no way the responsibility of Professor Junger; Ms. Jensen, for personal reasons, is not similarly absolved. The CWRU School of Law library staff—particularly Patricia J. Harris, Associate Librarian, and Mary Ledoux, Reference Librarian—also provided invaluable assistance in the preparation of this article.

All references and citations to I.R.C. sections in this article are to sections of the Internal Revenue Code of 1986, as amended to the date of publication, unless otherwise indicated. All references and citations to Treasury regulations are to the most current regulations unless otherwise indicated.

¹ 476 U.S. 593 (1986).

² 107 S. Ct. 1732 (1987).

³ See, e.g., Aidinoff & Lopata, *Section 461 and Accrual-Method Taxpayers: The Treatment of Liabilities Arising from Obligations to be Performed in the Future*, 33 TAX LAW. 789 (1980); Cunningham, *A Theoretical Analysis of the Tax Treatment of Future Costs*, 40 TAX L. REV. 577 (1985); Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1 (1984); Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506 (1986);

important practical issue as well. All other things being equal, informed taxpayers seek to accelerate deductions and to defer the inclusion of income.⁴ On an issue of such importance, one expects the Supreme Court, when it exercises its discretionary jurisdiction twice within such a short period of time, to promulgate well-crafted, thoughtful opinions.

But the Court wrote as neither craftsman nor theoretician. The cases apply the same prong of the "all events" test, which addresses the timing issue.⁵ Nevertheless, the cases fit together poorly, if at all, and the Court's attempted reconciliation reflects an analysis made at the most mundane conceptual level. Moreover, the two decisions are of surprisingly limited scope. The Tax Reform Act of 1984

Jensen, *The Deduction of Future Liabilities by Accrual-Basis Taxpayers: Premature Accruals, the All Events Test, and Economic Performance*, 37 U. FLA. L. REV. 443 (1985); Johnson, *Silk Purses from a Sow's Ear: Cost Free Liabilities Under the Income Tax*, 3 AM. J. TAX POL'Y 231 (1984); Lokken, *The Time Value of Money Rules*, 42 TAX L. REV. 1 (1986); McMahon, *Reforming Cost Recovery Allowances for Debt Financed Depreciable Property*, 29 ST. LOUIS U.L.J. 1029 (1985); Note, *Salvaging Accrual Method Deductions: Adding a "Time Value of Money" Component to the "All Events" Test*, 40 TAX LAW. 185 (1986).

⁴ The taxpayer desires to pay taxes later rather than sooner. See M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 5 (4th ed. 1985). A tax bill of \$x to be paid next year is, in present value terms, less of an obligation than a tax bill of \$x to be paid today. Thus, all other things being equal, a one-dollar deduction that currently offsets otherwise taxable income is, from the taxpayer's perspective, preferable to a one-dollar deduction to be taken only in a future taxable year. See Bradley & Winslow, *Self-Insurance Plans and Captive Insurance Companies — A Perspective on Recent Tax Developments*, 4 AM. J. TAX POL'Y 217, 230 (1985). Of course, if all other things are not equal, this general proposition may not hold true. For example, if the taxpayer expects to be subject to taxation at a much higher marginal rate in the next taxable year, deferring a deduction into that year, thereby offsetting income that would otherwise be taxed at the higher rate, may be beneficial.

Today every law student taking the basic course in federal income taxation gains at least some rudimentary idea about the importance of the time value of money. However, theoretical sophistication in this area is a relatively recent phenomenon, and Congress has only in this decade begun to incorporate time value concepts into the Internal Revenue Code. Professor Surrey, noting that economist E. Cary Brown had been credited with "discovering" the deferral effects of accelerated depreciation in 1948, commented that "perhaps a Congressman can be pardoned for not appreciating the benefit of deferral if its ramifications apparently eluded public finance specialists for 35 years of our income tax history." S. SURREY, *PATHWAYS TO TAX REFORM* 123 (1973) (citing the reference to Brown in C. SHOUP, *PUBLIC FINANCE* 302 n.20 (1969)).

⁵ See *infra* notes 13-17 and accompanying text.

substantially modified the law governing the timing of deductions,⁶ but neither case involved facts governed by the new statute.⁷ Finally, in the cursory majority opinion in *General Dynamics*, the Court made a misleading suggestion about the law after the Tax Reform Act of 1984 and advanced an ill-considered proposition about the construction of tax statutes. Indeed, the opinion evidences an astonishing lack of both research and analysis.⁸ Shoddy judicial work warrants criticism for its own sake, and criticism is particularly justified when the Supreme Court misreads, and therefore possibly misdirects, post-1984 Act law.

Section I of this article outlines the "all events" test and describes the procedural history of *Hughes Properties* and *General Dynamics*.⁹ Section II critically examines the formalistic basis for the inconsistent resolutions of the two cases.¹⁰ Section III discusses the changes made by the Tax Reform Act of 1984 that affect the timing of deductions and responds to the Supreme Court's suggestion about the effect of those changes upon a factual situation like that of *General Dynamics*.¹¹ Finally, section IV considers the use in *General Dynamics* of insurance company taxation principles outside the insurance company

⁶ Pub. L. No. 98-369, § 91(a), 98 Stat. 494, 598-600 (1984) (adding new I.R.C. § 461(h)). See Jensen, *supra* note 3, at 477-89; *infra* notes 102-15 and accompanying text.

⁷ Nevertheless, the long audit periods of large corporations make interpretations of former law significant for a substantial number of taxpayers. For some ruminations about why the Court might have granted certiorari in the wake of the statutory changes, see Jensen, *Hughes Properties and General Dynamics: The Supreme Court, the All Events Test, and the 1984 Tax Act*, 32 TAX NOTES 911, 911-12 (1986).

⁸ See *infra* notes 120-60 & 165-92 and accompanying text. Perhaps the lack of research and analysis is not so astonishing. In commenting on Court assignments to draft opinions, Justice Harry Blackmun noted, "If one's in the doghouse with the Chief [Justice], he gets the crud. He gets the tax cases, and some of the Indian cases, which I like but I've had a lot of them." Taylor, *Reading the Tea Leaves of a New Term*, N.Y. Times, Dec. 22, 1986, at B14, col. 6. Blackmun's comment appears to reflect a general sentiment among the Justices. See B. WOODWARD & S. ARMSTRONG, *THE BRETHREN* 362 (1980) ("This is a tax case. Deny." That was Brennan's normal reaction to a [certiorari] request in a tax case."); Taylor, *Powell on His Approach: Doing Justice Case by Case*, N.Y. Times, July 12, 1987, at A18, col. 3 (quoting Justice Powell: "A dog is a case that you wish the Chief Justice had assigned to some other Justice[,] . . . a tax case, for example").

⁹ See *infra* notes 13-46 and accompanying text.

¹⁰ See *infra* notes 47-101 and accompanying text.

¹¹ See *infra* notes 102-60 and accompanying text.

context. Section IV also joins the debate over whether additions to accounting reserves should ever be deductible without specific statutory authority.¹²

I. THE ALL EVENTS TEST, *Hughes Properties*, AND *General Dynamics*

A. *The All Events Test*

An accrual-basis taxpayer¹³ generally need not wait until a liability has been paid or otherwise satisfied in order to deduct the amount

¹² See *infra* notes 161-208 and accompanying text.

¹³ The Internal Revenue Code generally requires a taxpayer to compute taxable income under the same method of accounting that it regularly uses for financial accounting. I.R.C. § 446(a). "Method of accounting," for this purpose, includes overall methods of accounting such as the cash receipts and disbursements method, an accrual method, some combination of the two, or one of the other methods permitted by Treas. Reg. § 1.446-1(c). Taxpayers that are required to use inventories for a particular trade or business must generally use an accrual method of accounting for their purchases and sales, Treas. Reg. § 1.446-1(c)(2)(i), and inventories are required in all cases in which the production, purchase, or sale of merchandise is an income-producing factor. Treas. Reg. § 1.471-1. Moreover, I.R.C. § 448, added by Tax Reform Act of 1986, Pub. L. No. 99-514, § 801(a), 100 Stat. 2085, 2345, generally forbids certain organizations (C corporations, partnerships with C corporations as partners, and tax shelters) from using the cash receipts and disbursements method.

Accrual principles have been described in the following way:

(1) Revenues are recognized as entering into the determination of income when sales are made or services are rendered.

(2) The mere receipt of money or the promise of another person to pay money for the goods or services does not represent revenue which should be recognized in the period of receipt if it is burdened with an obligation to deliver goods or render services in the future. Items of this nature are treated as resulting in liabilities or deferred credits until they are earned through the fulfillment of the required performances.

(3) Costs and expenses directly identifiable with revenues are chargeable against the income of the period in which the revenues are recognized. Expenses, such as insurance, rent, property taxes and interest, which are for particular periods of time are chargeable over such periods. Other expenses incurred in the general conduct of the business are chargeable against the income of the period in which they are incurred unless it is clearly evident that they are for the benefit of future periods and there is a reasonable basis, both as to amount and time, for allocating them to future periods, in which event they should be deferred and charged to such periods.

(4) If the precise amount of any costs or expenses is not determinable at the time they are chargeable against income, they should be

of the obligation. Traditional timing principles—those in effect prior to modification by the Tax Reform Act of 1984—permitted a deduction when a liability had been “incurred,” that is, when the two requirements of the all events test had been met.¹⁴

Under the Treasury regulations that set out the test, a taxpayer subject to the pre-1984 Act rules (such as the taxpayers in *Hughes Properties* and *General Dynamics*) must demonstrate that “all the events have occurred which determine the fact of the liability” and that “the amount thereof can be demonstrated with reasonable accuracy.”¹⁵ To show the fact of the liability, the taxpayer must in general demonstrate the absence of contingencies (other than the obligor’s ability to pay) that could defeat the liability.¹⁶ To show the amount of the liability, the taxpayer must provide more than a rough estimate, although absolute precision is not necessary.¹⁷

In both *Hughes Properties* and *General Dynamics*, the Internal Revenue Service contended that, in the taxable years in question, the taxpayers had not met the requirements of the all events test with respect to certain claimed deductions, and that the deductions

recognized on the basis of reasonable estimates.

(5) Accounting recognition of costs and expenses which cannot be determined with a reasonable degree of accuracy at the time they would otherwise be charged against income of a particular period should be deferred until such determination is possible.

Stanger, Vander Kam, & Polifka, *Prepaid Income and Estimated Expenses: Financial Accounting Versus Tax Accounting Dichotomy*, 33 TAX LAW. 403, 405 (1980).

¹⁴ This article considers only timing issues, that is, the proper taxable year for a deduction to be taken. It is assumed that statutory authority (such as I.R.C. § 162, see *infra* note 27) exists for any deduction.

¹⁵ Treas. Reg. § 1.461-1(a)(2).

¹⁶ See, e.g., *Brown v. Helvering*, 291 U.S. 193 (1934), described in the text at *infra* note 164 and accompanying text. See also Jensen, *supra* note 3, at 453-54 (discussing *Brown*).

Although the taxpayer must in general show the absence of contingencies, the test does not require absolute certainty. Contingencies of some sort always exist until satisfaction of the liability (such as by payment). The cases have phrased the issue in terms of the absence of contingencies, but the underlying question appears to be “How contingent is too contingent?”. See Jensen, *supra* note 3, at 455-56; Bradley & Winslow, *supra* note 4, at 227 n.36.

¹⁷ See Jensen, *supra* note 3, at 462-67; see generally Comment, *Accrual and Unusual Punishment—The Reasonable Accuracy Requirement of the All Events Test*, 25 UCLA L. REV. 70 (1977).

were therefore improper in those years.¹⁸ The Service challenged timing only—not the taxpayers' rights to deduct the amounts in issue at some point—but fortunes have been won and lost as a result of disputes involving "only" timing.

*B. Hughes Properties: Casino's Liability to Pay Slot Machine Progressive Jackpots*¹⁹

Hughes Properties, Inc. (Hughes), an accrual-basis taxpayer, owned a Nevada gambling casino. The casino included several special slot machines that provided for "progressive" jackpots, jackpots that increased over time, based on the amount of machine usage, until either the jackpots were won or maximum figures were reached.

Each progressive slot machine had a "payoff indicator" that showed casino customers the current level of the jackpot, and the indicator figure at any time represented a guaranteed minimum jackpot. Strictly-enforced Nevada Gaming Regulations forbade turning back the indicator to a lesser amount except on payout to a winning player or upon machine malfunction.²⁰ Moreover, if a machine was to be taken out of service, the Nevada Gaming Commission required either that the machine be played until payoff or that the unpaid jackpot liability be transferred to another machine that continued in service.²¹

Gaming Regulations required that every progressive jackpot that was won be paid. Any casino that wrongfully refused to pay a guaranteed jackpot to a winning customer faced potentially severe administrative sanctions, including license revocation.²² In addition, since 1977, the last year at issue in *Hughes Properties*, the Gaming Commission has required casinos to maintain cash reserves sufficient

¹⁸ *United States v. Hughes Properties, Inc.*, 476 U.S. 593, 597, 601 (1986); *United States v. General Dynamics Corp.*, 107 S. Ct. 1732, 1735 (1987).

¹⁹ The description of the facts of *Hughes Properties* is taken from my earlier article, Jensen, *supra* note 7, at 913-14.

²⁰ Nev. Gaming Regs. § 5.110.2 (1972).

²¹ Joint Appendix, *United States v. Hughes Properties*, 476 U.S. 593 (1986) (No. 85-554) (affidavit of Peter Echeverria, member of Nevada Gaming Commission). The jackpot obligation did not disappear if a casino sold its entire business. The Commission required the buyer to continue the progressive machines in play with initial jackpots no smaller than those on the machines at the time of sale. *Id.*

²² NEV. REV. STAT. ANN. § 463.310 (Michie 1986).

to pay the guaranteed amounts on their progressive machines.²³

The average period between payoffs for most of the casino's progressive machines was 4-1/2 months, although the periods varied greatly, ranging from a low of 1.9 months to a high of 14.3 months. Two of the twenty-four machines had been in operation for extended periods (13 and 35 months) with no payoff,²⁴ but it was understood that all machines possessed a real possibility of payoff and that Nevada law required that there be such a possibility.²⁵

At the end of each taxable year, Hughes calculated the sum of the payoff indicator amounts for all progressive machines. From that figure, Hughes subtracted the equivalent figure that had been computed at the end of the prior year. Hughes treated the increase in the future payoff liability²⁶ as a deductible ordinary and necessary business expense.²⁷

The Internal Revenue Service agreed that Hughes, through use of the payoff indicator figures, had demonstrated the amount of liability with reasonable accuracy.²⁸ The Commissioner contended, however, that the fact of the liability with respect to each slot machine occurred only upon a winner's pull of that machine's handle.²⁹ The Commissioner had successfully employed such an argument in a similar case involving another Nevada casino, *Nightingale v. United States*,³⁰ where the Ninth Circuit concluded:

The one, indispensable . . . event is the winning of the progressive jackpot by some fortunate gambler. . . . Gambling being what it is, and gambling odds being what they are, it is entirely possible that no actual liability will ever occur. . . . [T]here is no way of knowing when any par-

²³ Nev. Gaming Regs. § 5.110.3 (1977).

²⁴ *Hughes Properties*, 476 U.S. at 596 n.1.

²⁵ *Id.* at 595-96. In fact, all jackpots unpaid as of the end of the last taxable year in issue were subsequently won. *Id.* at 602 n.3.

²⁶ For example, if a machine showed progressive jackpots of \$1,000 at the beginning of the year and \$5,000 at the end of the year, Hughes would have treated \$4,000 as the deductible amount attributable to that machine.

²⁷ The Internal Revenue Code permits the deduction of "ordinary and necessary expenses . . . incurred during the taxable year in carrying on any trade or business." I.R.C. § 162(a).

²⁸ Brief for the United States at 13, *Hughes Properties* (No. 85-554).

²⁹ *Hughes Properties*, 476 U.S. at 597.

³⁰ 684 F.2d 611 (9th Cir. 1982).

ticular progressive "one armed bandit" will pay off, nor what the amount of that payoff will then be.³¹

In spite of *Nightingale*, both the Claims Court³² and the Federal Circuit³³ held for Hughes, viewing the liability as fixed by Nevada law at midnight on the last day of the fiscal year. The courts concluded that the casino satisfied the all events test upon the final play of the machine before year's end, "that is, the last change in the jackpot amount before the amount is recorded for accounting purposes."³⁴ With the conflict between the Ninth and Federal Circuits, the government petitioned for certiorari.

*C. General Dynamics: Employer's Self-Insurance Liability to Reimburse Employees' Medical Expenses*³⁵

Collective bargaining agreements required General Dynamics and its affiliated corporations (collectively, GD) to maintain health insurance coverage for GD employees. In 1972, GD, which had previously funded plans through private insurance carriers, took over the insurance function itself.³⁶ GD established reserves to meet its estimated liability and retained the two insurance firms that had earlier provided coverage to evaluate and approve benefit claims. On its tax return for 1972, GD deducted its liability for medical services assumed to have been performed during the year as an ordinary and necessary business expense. Thus, GD deducted not only its liability for those employees whose claims had been approved during the year, but also its estimated liability for claims during the year that

³¹ *Id.* at 614.

³² *Hughes Properties, Inc. v. United States*, 5 Cl. Ct. 641, 645 (1984).

³³ *Hughes Properties, Inc. v. United States*, 760 F.2d 1292, 1293 (Fed. Cir. 1985).

³⁴ 5 Cl. Ct. at 645; 760 F.2d at 1293.

³⁵ The description of the facts of *General Dynamics* is taken from Jensen, *supra* note 7, at 918-20.

³⁶ *United States v. General Dynamics Corp.*, 107 S. Ct. 1732, 1734-35 (1987). That is, GD took over the obligation to reimburse employees for medical expenses covered under the plan; GD was therefore providing insurance for its employees. Although the new arrangement was called "self-insurance," from GD's perspective it technically was not insurance at all because GD shifted none of its own risk to another, unrelated party. See Barker, *Federal Income Taxation and Captive Insurance*, 6 VA. TAX REV. 267, 280 (1986); Crane, *Anticipation and the Accrual Method Revisited*, 1986-87 PREVIEW OF UNITED STATES SUPREME COURT CASES 281, 282 (1987).

had either not yet been filed, or, if filed, had not yet been approved.³⁷

The Commissioner denied the deductions for the estimates,³⁸ even though the estimates were based on the actuarial principles used by the insurance industry for determining such "incurred but not reported" (IBNR) claims.³⁹ The Commissioner contended that a deduction should not be permitted until a plan administrator had approved a claim. Until such approval, GD could not establish a liability in fact because either an employee might not file a claim or the administrator might deny the claim.⁴⁰ In the government's view, then, any deduction permitted would be with respect to "expenses that [GD] may never incur at all."⁴¹

³⁷ *General Dynamics*, 107 S. Ct. at 1734-35. GD did not deduct any part of the self-insurance reserves on its original return. Upon commencement of an Internal Revenue Service audit, however, GD filed an amended return and claimed a deduction for the additions to the reserves. *Id.* at 1735.

The deductibility of premiums actually paid to the insurance companies by GD in prior taxable years was appropriately not at issue. But taxpayers have been imaginative in seeking to obtain deductions for arrangements, such as self-insurance or premium "payments" to captive insurance companies, that do not result in relinquishing control over the deducted funds. See generally Barker, *supra* note 36; Bradley & Winslow, *supra* note 4. As a result, the Internal Revenue Service has vigorously challenged deductibility under such plans.

³⁸ Under the all events test, there was no dispute over deductibility of those claims already approved but not yet paid. The absence of dispute demonstrates the all events test's failure to take account of the time value of money. If payment is delayed for any significant amount of time after deduction of the liability, the taxpayer may receive a sizeable economic benefit from the accelerated deduction. See *infra* notes 94-101 and accompanying text.

³⁹ Under the guidance of its insurance company administrators, GD followed actuarial principles, but it did not claim to be an "insurance company" entitled for that reason to deduct additions to reserves. See I.R.C. § 807 (permitting deduction for additions to reserves by life insurance companies); I.R.C. § 832(b)(5) (permitting deduction for additions to reserves by non-life insurance companies); *infra* notes 165-92 and accompanying text.

⁴⁰ The administrator was required to determine "whether the medical procedures were covered by the health plans, whether stipulated maximum charges had been exceeded, and whether the treatment was medically necessary." Supplemental Memorandum for the United States at 2, *United States v. General Dynamics Corp.*, 107 S. Ct. 1732 (1987) (No. 85-1385). About 90% of the amounts for which GD's employees claimed reimbursement had historically been approved for payment. *General Dynamics Corp. v. United States*, 6 Cl. Ct. 250, 254 (1984).

⁴¹ Petition for Writ of Certiorari at 8, *General Dynamics* (No. 85-1385). See also Brief for United States at 11, *General Dynamics* (No. 85-1385):

It is true that [GD, once medical services have been provided to an

GD prevailed at both the Claims Court⁴² and Federal Circuit⁴³ levels. Those courts held that the last event necessary to fix liability was the "occurrence of the insured event,"⁴⁴ that is, the provision of medical services. Although the lower courts had ruled against the government with respect to both prongs of the all events test,⁴⁵ the government limited its petition for Supreme Court review to the "fact of liability" question.⁴⁶

II. THE SUPREME COURT DECISIONS

A. Applying the First Prong of the All Events Test: Imagining Contingencies

As presented to the Supreme Court, both *Hughes Properties* and *General Dynamics* involved only one ultimate question: when can a taxpayer successfully demonstrate the fact of a liability, the first prong of the all events test? The government did not question in either case the "reasonable accuracy" of the amount claimed as a

employee,] . . . reasonably can anticipate that it will have a future obligation to reimburse the employee if he files a claim and his claim is approved. But this anticipated obligation is no more certain than the future liability that [GD] could have anticipated at the time it originally entered into the collective bargaining agreements under which the health plans were created.

⁴² *General Dynamics Corp. v. United States*, 6 Cl. Ct. 250 (1984).

⁴³ *General Dynamics Corp. v. United States*, 773 F.2d 1224 (Fed. Cir. 1985).

⁴⁴ 6 Cl. Ct. at 255 (emphasis in original deleted); 773 F.2d at 1225.

⁴⁵ The lower courts viewed the estimate for taxable year 1972 as reasonably accurate even though the company later paid only 82.2% of the reserved amount for claims. 6 Cl. Ct. at 256; 773 F.2d at 1226.

⁴⁶ The government did not agree with the lower court's ruling on the amount of liability because of the discrepancy of nearly 20% between amounts deducted and amounts ultimately paid. See *supra* note 45. However, it abandoned the issue in this case because of the difficulty of overturning a fundamentally factual determination on appeal. Petition for Writ of Certiorari at 13 n.2, *General Dynamics* (No. 85-1385); Brief for United States at 33 n.10, *General Dynamics* (No. 85-1385).

General Dynamics would have been a particularly good case for the Court to hear on the amount of liability if that issue had been necessary to the Court's resolution of the case. An overestimation of liabilities can provide a substantial economic benefit to a taxpayer permitted an accelerated deduction. See Jensen, *supra* note 3, at 466-67 (discussing treatment of overestimates); *infra* notes 84-93 and accompanying text (suggesting *General Dynamics* necessarily implicated reasonable accuracy question).

deduction. The government conceded that point at the outset in *Hughes Properties*, and it limited its petition for certiorari to the fact of liability issue in *General Dynamics*.

In *Hughes Properties*, the Court ruled for the taxpayer. By a 7-2 vote,⁴⁷ the Court held that the obligation imposed by the Nevada statute and regulations fixed a liability in fact at the end of the casino's taxable year. The casino had therefore properly deducted each year's aggregate increase in the payoff indicator levels. In reaching that conclusion, the Court resolved a number of issues that had puzzled lower courts and commentators prior to the Tax Reform Act of 1984. For example, the Court held that an obligation under state law can fix a liability prior to the performance that satisfies the liability.⁴⁸ Moreover, a liability can be fixed even though both the ultimate payee⁴⁹ and the time of

⁴⁷ Justice Blackmun authored the opinion joined by Justices Brennan, White, Marshall, Powell, Rehnquist, and O'Connor. Justice Stevens's dissent was joined by Chief Justice Burger.

⁴⁸ "[A]s a matter of state law, [Hughes] had a fixed liability for the jackpot which it could not escape." *United States v. Hughes Properties, Inc.*, 476 U.S. 593, 602 (1986). This issue had been important, for example, in cases involving statutorily mandated reclamation obligations associated with strip mining. *See, e.g., Ohio River Collieries Co. v. Comm'r*, 77 T.C. 1369, 1374 (1981) (holding that state statute fixed, in year land was disturbed, strip miner's obligation to reclaim mined land); *see also* Jensen, *supra* note 3, at 455-61 (discussing *Ohio River Collieries*); Note, *Ohio River Collieries v. Commissioner: Satisfying the Fixed Liability Requirement Through a Statutory Duty to Act*, 3 VA. TAX REV. 215 (1983). In *Ohio River Collieries*, the reasonable accuracy of the future reclamation obligation had been stipulated, and the taxpayer was permitted a current deduction for the undiscounted amount of the reclamation obligation to be fulfilled in subsequent taxable years. *See also* I.R.C. § 468, as amended by Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1807(a)(3)(A), 1807(a)(3)(C), 1899A(14), 100 Stat. 2085, 2811, 2959 (1984 Act addition setting out special rules for certain future mining reclamation costs).

⁴⁹ "The obligation is there, and whether it turns out that the winner is one patron or another makes no conceivable difference as to basic liability." *Hughes Properties*, 476 U.S. at 602. The Service had argued in many cases, generally unsuccessfully, that a liability was necessarily contingent until some person exists who can assert a claim against the taxpayer. *See, e.g., Kaiser Steel Corp. v. United States*, 717 F.2d 1304 (9th Cir. 1983) (permitting current deduction to cover uncontested liabilities, under worker's compensation laws, arising from injuries to employees); *Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969) (permitting current deduction of accrued, but unpaid, contributions to newspaper dealer profit-sharing plan); *Ohio River Collieries Co. v. Comm'r*, 77 T.C. 1369 (1981) (permitting current deduction for future strip mining reclamation obligation even though identity of party to perform reclamation was unknown).

payment⁵⁰ may be unknown. Finally, the Court determined that a liability can be fixed even though the obligor may be able to avoid payment through its own voluntary acts, such as surrendering its license or filing for bankruptcy, as long as those possibilities are remote.⁵¹

Although generous to the taxpayer in many respects, particularly in its disregard of time value of money considerations,⁵² the decision in *Hughes Properties* was seen as a reasonable accommodation of the "competing interests in permitting accrual accounting and protecting the public fisc."⁵³ In *Hughes Properties* the Court seemed to take a step in the direction of predictability of result for those

⁵⁰ On the timing issue, the Court simply stated that "only the exact time of payment and the identity of the winner remained for the future." *Hughes Properties*, 476 U.S. at 604. In an aside, the Court noted that the government's brief "speaks of the time value of money," *id.*, but it rejected that issue as a serious one on these facts. *Id.* ("since the casino of course must pay taxes on the income it earns from the use of as-yet-unwon jackpots, the Government vastly overestimates the time value of [Hughes'] deductions"). But see *infra* notes 94-101 and accompanying text (arguing that the time value of money is the issue in such cases).

A simple example will illustrate the importance of the timing question. Assume that a gambling concern collects \$100 in wagers in year one, all of which it is committed (unrealistically) to pay out in winnings, but not until year two. In year two, the concern will collect another \$100, to be paid out the following year, and so on. If the taxpayer is permitted a \$100 deduction in each year, reflecting its future obligations, it will never have net income from gambling. Its only taxable income will be the investment income earned on the as-yet-unpaid jackpots. If the taxpayer is not permitted the \$100 deduction in year one, however, it will have to pay taxes for that year on the full \$100. (If the applicable marginal rate is 46%, only \$54 will remain after taxes.) As in the first case, the net gambling income in future years is zero, and the taxpayer will have to pay taxes on investment income earned on the reserved amounts. But the \$46 paid in taxes on the first year's gambling income is gone, and the taxpayer loses forever the earnings on that amount.

⁵¹ "The existence of an absolute liability is necessary; absolute certainty that it will be discharged by payment is not." *Hughes Properties*, 476 U.S. at 606 (quoting *Helvering v. Russian Fin. & Constr. Corp.*, 77 F.2d 324, 327 (2d Cir. 1935)). The Court suggested that the inclusionary tax benefit rule would require the later inclusion of any amounts deducted that were not, in fact, paid. *Hughes Properties*, 476 U.S. at 605 (citing *Treas. Reg. § 1.461-1(a)(2)*). The Court ignored the fact that the tax benefit rule does not take account of the time value of money. See *Jensen, supra* note 7, at 915 n.48.

⁵² See *supra* note 50; *infra* notes 94-101 and accompanying text.

⁵³ E.g., *United States v. General Dynamics Corp.*, 107 S. Ct. 1732, 1740 (1987) (O'Connor, J., dissenting).

cases controlled by the all events test, a step that led at least one commentator to predict a victory for the taxpayer in *General Dynamics*.⁵⁴

The prediction was wrong.⁵⁵ Instead, by a 6-3 margin,⁵⁶ the Court concluded in *General Dynamics* that an employer's medical reimbursement liability would not be fixed until an employee filed a health expense benefits claim form.⁵⁷ The Court stopped short of fully accepting the government's proffered theory that both filing and approval of a claim should be necessary to satisfy the all events test.⁵⁸ But the decision nevertheless effectively constituted a total defeat for the taxpayer because GD lost more than its deduction for amounts reflecting claims not yet filed. GD failed to establish a record at trial separating filed but as yet unapproved claims from unfiled (and therefore necessarily unapproved) claims.⁵⁹ Consequently, the full amount of the deduction for unapproved claims was disallowed.⁶⁰

⁵⁴ See Jensen, *supra* note 7, at 920-21; cf. Crane, *supra* note 36, at 282-83.

⁵⁵ The predictor will not concede, however, that he was wrong on the merits. See *infra* notes 77-83 and accompanying text.

⁵⁶ Justice Marshall wrote for a majority consisting also of Chief Justice Rehnquist and Justices Brennan, White, Powell, and Scalia. Justice O'Connor's dissent was joined by Justices Blackmun and Stevens.

⁵⁷ *General Dynamics*, 107 S. Ct. at 1736 (stating that "General Dynamics was . . . liable to pay for covered medical services *only* if properly documented claim forms were filed") (emphasis in original).

⁵⁸ Brief for United States at 35, *General Dynamics* (No. 85-1385).

⁵⁹ *General Dynamics*, 107 S. Ct. at 1737. The Court noted the general proposition that the taxpayer must show its entitlement to a deduction, citing *Helvering v. Taylor*, 293 U.S. 507, 514 (1935). GD unquestionably had not provided the evidence that the Supreme Court said was needed to justify a deduction for filed but as yet unapproved claims. Of course, GD was working under the understanding, supported by two lower court decisions, that the standards it had to meet were different from those enunciated by the Supreme Court. In such a case, it seems appropriate to remand the case to provide the taxpayer the chance to meet the newly enunciated standards.

⁶⁰ Five stages in the lifespan of employees' claims under an employer's self-insurance program can be posited. First, for estimates associated with medical services not yet performed and claims therefore not yet filed, GD took no deductions, consistent with the common understanding of the all events test. Second, with respect to services performed but claims not filed, GD had taken deductions—inappropriately, under the Supreme Court's decision. Third, for additions to reserves associated with claims filed but not yet approved, the government had argued that a deduction was not permissible, but GD apparently would have

The Supreme Court's willingness to speculate was strikingly different in the two cases. In *General Dynamics*, the Court decided that as a matter of law the fact of liability did not occur until the filing of employees' claims,⁶¹ and that failure to file was not an "extremely remote and speculative possibility" of the sort considered in *Hughes Properties*.⁶² The Court made this determination without the benefit of factual findings below. The Claims Court had viewed GD's claims evaluation as "ministerial in nature," therefore not creating any contingency,⁶³ but it made no findings with respect to the filing of claims.⁶⁴ Nevertheless, aided by the government's briefs, the Supreme Court imagined its own contingencies:⁶⁵

Some covered individuals, through oversight, procrastination, confusion over the coverage provided, or fear of disclosure to the employer of the extent or nature of the services received, might not file claims for reimbursement to which they are plainly entitled. Such filing is not a mere technicality. It is crucial to the establishment of liability on the part of the taxpayer.⁶⁶

prevailed if it had proven the deductible amount attributable to such claims. Fourth, for approved but unpaid claims, there was no dispute about deductibility, see *supra* note 38, and, a fortiori, paid and previously undeducted claims, the fifth category, were deductible.

⁶¹ *General Dynamics*, 107 S. Ct. at 1736 n.4. The filing was "a true condition precedent to liability on the part of [GD]." *Id.* at 1736 n.5.

⁶² *Id.* at 1736; *United States v. Hughes Properties, Inc.*, 476 U.S. 593, 601-02 (1986).

⁶³ 6 Cl. Ct. at 254; 107 S. Ct. at 1736 n.4.

⁶⁴ *General Dynamics*, 107 S. Ct. at 1736 n.4. GD conceded arguendo that a "few employees" entitled to file claims did not do so, Brief for Respondents at 18, *General Dynamics* (No. 85-1385), but the record is silent, and the Claims Court made no findings, on that issue. The record does indicate that employees occasionally filed claims later than required by the terms of the plans, and GD technically had no obligation in such cases. Even substantially late claims (filed two years or more after provision of services), however, were processed. Joint Appendix at 131, *General Dynamics* (No. 85-1385) (testimony of J. David Loftus, Aetna Life Insurance Co., one of the administrators of GD's plans).

⁶⁵ GD employed 56,000 people, see Stipulation of Facts, Joint Appendix at 25, *General Dynamics* (No. 85-1385), and obviously some persons entitled to file claims failed to do so. The Supreme Court dealt only with hypothetical contingencies, however. The Court's opinion does not depend on the existence of an actual non-filer.

⁶⁶ *General Dynamics*, 107 S. Ct. at 1736.

Creating this list of imagined contingencies apparently involved at least a modicum of critical evaluation by the Court because the Court did not accept, or at least did not repeat, all of the reasons suggested by the government that might lead to failure to file a claim. For example, the government had speculated that "[s]ome [employees] might regard the medical expenses that they had incurred as too insignificant to warrant the trouble of seeking reimbursement."⁶⁷ Such a statement obviously reflects the youth, vigor, and health of government attorneys. Many Justices have more experience with the high cost of medical care, however, and the Court did not embrace this speculation.

But the Court's critical evaluation was limited. Inadvertence and neglect were unlikely, although not impossible, because hospitals generally sent bills directly to GD. GD in turn "would inquire of the employee if a claim form covering that hospitalization was not turned in."⁶⁸ Even bills sent directly to employees had a built-in "tickler" system because the providers of the medical services were unlikely to let GD employees forget unpaid bills. Moreover, filing a claims form was a simple task.⁶⁹ It should have been difficult, but apparently it was not impossible, for even the most visionary Justice to imagine an employee's failure to file a simple claims form after being reminded to do so.⁷⁰

In contrast, the *Hughes Properties* Court had not engaged in serious speculation about nonpayment by the casino, apart from the "remote" possibilities of license surrender or voluntary bankruptcy. But why not? Suppose, for example, a progressive jackpot winner walks away from his winnings. Bells ring, lights flash, and casino employees (and Internal Revenue Service agents) descend upon the winning machine, but the apparent winner does not claim

⁶⁷ Brief for United States at 35, *General Dynamics* (No. 85-1385).

⁶⁸ Brief for Respondent at 18, *General Dynamics* (No. 85-1385); Joint Appendix at 175, *General Dynamics* (No. 85-1385) (deposition testimony of C. Robert Schaal, Prudential Insurance Co., one of GD's plan administrators).

⁶⁹ Joint Appendix at 174-75, *General Dynamics* (No. 85-1385). The testimony indicates that GD and its administrators sought to make the filing process as simple and convenient as possible for employees.

⁷⁰ The Court's other suggestions are also questionable. For example, even assuming a willingness to forgo reimbursement, it is unlikely that an employee can keep secret from an employer the "extent" of medical services if significant absence from work is involved.

entitlement to the riches. Perhaps he wishes his identity not to be disclosed to the government for other reasons. Or perhaps his spouse thinks that, at the time he is anonymously playing the slot machines in Las Vegas, he is elsewhere; and several thousand dollars in the family bank account (and on the family's tax bill⁷¹) would be difficult to explain. Unlikely? Certainly.⁷² Unimaginable? No. Is the claim for payment that a winning jackpot player must make⁷³ therefore a "mere technicality" as the reasoning of the *General Dynamics* Court suggests?⁷⁴

If the order of the two cases had been reversed, and the *Hughes Properties* litigants had been faced with the language of the opinion in *General Dynamics*, one would have expected an extensive argument about whether the claim for payment of the jackpot "is crucial to the establishment of liability on the part of the taxpayer."⁷⁵ Instead, the opinion in *Hughes Properties* is silent on the potentially dispositive waiver issue.⁷⁶

Hughes Properties does not address the waiver issue for good reason. In only a very limited sense does a casino not have a

⁷¹ This hypothetical assumes that the unwilling winner can avoid the tax liability by refusing to accept the progressive jackpot. If the taxpayer is deemed to have received the prize under the doctrine of constructive receipt, and if the Internal Revenue Service makes its presence known, spouse evasion may be impossible.

⁷² As the dissenters in *General Dynamics* put it, the speculative possibility [that an employee might not file a medical expenses claim] differs not at all from the speculation in *Hughes Properties* that a jackpot might never be paid by a casino. . . . The beneficiary of a liability always has the option of waiving payment, but a taxpayer is still unquestionably entitled to deduct the liability. 107 S. Ct. at 1739 (O'Connor, J., dissenting).

⁷³ Although casino procedure falls outside the author's expertise, it appears from the record that a progressive jackpot winner must make a claim for payment in order to receive the prize. See, e.g., Joint Appendix, *United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986) (No. 85-554) (affidavit of John H. Stratton, member of Nevada Gaming Control Board) (describing procedures to be followed upon complaint from casino customer that casino has wrongfully refused to pay progressive jackpot). A nominal winner should therefore be able to waive his winnings by making no claim.

⁷⁴ See *supra* text accompanying note 66.

⁷⁵ *General Dynamics*, 107 S. Ct. at 1736.

⁷⁶ One reason for the difference in the two opinions is that the government presented the Supreme Court with more speculative contingencies in *General Dynamics* than it did in *Hughes Properties*. But that basis for distinction does not carry one very far in understanding why the Court was willing to evaluate suggested contingencies that were not based on factual findings of a trial court.

liability to pay any prize until presentation of a valid claim. (This is so even if the effect of a winner's failure to file a claim were to discharge the casino's jackpot obligation fully with respect to that machine.⁷⁷) For example, consider an accrual-basis corporate taxpayer that contracts for cleaning services, the cost of which is deductible to the corporation. The possibilities that the cleaning company might not submit a bill or might not attempt collection—the conceptual equivalents of an employee's failure to file a claim⁷⁸ or a jackpot winner's failure to claim the jackpot—have never been considered contingencies that would defeat deductibility.⁷⁹

It is the speculation in *General Dynamics*, not the silence of *Hughes Properties*, that is noteworthy. *General Dynamics* represents

⁷⁷ To be sure, one can construct a theoretical justification for treating the potential waiver by a jackpot winner differently from the potential waiver of medical reimbursement by a GD employee: the liability in *Hughes Properties* with respect to a particular machine would not have disappeared altogether if one winner had declined his prize. Under Nevada law the casino presumably would have remained obligated to pay to the next willing winner a jackpot that included the previously unclaimed amount. See *supra* notes 20-23 and accompanying text. If the Court had distinguished the two cases on this basis, we could feel much more comfortable about its ignoring the waiver-of-payment issue. See *infra* notes 78-79 and accompanying text.

The parties and the Court did not view the dispute in those terms, however. The Service argued that the winning pull of the handle constituted the dispositive event, without regard to the possibility of waiver. Thus, the government emphasized when a claim could be made, not, as in *General Dynamics*, when it in fact had been made. See *Hughes Properties*, 476 U.S. at 602 (Service argued "until [a winning pull], there is no one who can make a claim for payment"). Although the Court ultimately rejected the government's argument, it took the argument seriously.

Moreover, the Court in *Hughes Properties* ignored the time value of money on the facts of the case. See *supra* note 50 and accompanying text. If one winner had waived his prize, it would have taken an additional 4-1/2 months, on the average, for another winner to come along, and it could have taken several years. See *supra* notes 24-25 and accompanying text. Once the possible period of non-payment lengthens—and it requires only a little imagination to extend the period considerably—it becomes much more difficult to dismiss time value of money concerns. See *infra* note 98.

⁷⁸ In the *General Dynamics* situation, the medical facility also provided services. That facility's possible failure to submit a bill also should not be treated as a fatal contingency because it is as remote a possibility as can be imagined.

⁷⁹ See Jensen, *supra* note 7, at 920-21; *supra* note 72; see also Crane, *supra* note 36, at 282 ("The government offers no suggestion that there is anything special about the method of presentation and approval involved in this case that would distinguish it from any other case in which services are rendered before a formal bill is presented and approved for payment.").

a retreat from the principle that an obligation may exist although there is a possibility that it will not be paid.⁸⁰ Tax advisors face real difficulties in explaining to clients the factors, if any, that justified different results in the two cases. As a practical matter, given the Court's difficulties at reconciliation, perhaps neither case has application beyond its narrow facts.⁸¹

The problems of a taxpayer in the post-*General Dynamics* world mirror the Supreme Court's own division: only five Justices were part of the majority in both cases, an unusual breakdown on a technical issue unlikely to evoke strong feelings.⁸² Strikingly, the authors of both the majority and dissenting opinions in *Hughes Properties* (Justices Blackmun and Stevens, respectively) thought the *General Dynamics* majority misapplied the principles set out only eleven months before in *Hughes Properties*.⁸³

B. The Second Prong of the All Events Test: Was It Implicated in General Dynamics?

The *General Dynamics* Court faced one insuperable problem in denying GD a deduction in 1972, while fitting the analysis comfortably within the traditional cases governing the all events test. The Court was presented with only the fact of liability issue. Be-

⁸⁰ See *Hughes Properties*, 476 U.S. at 607 (Stevens, J., dissenting) (distinguishing between nonpayment of existing obligation and nonexistence of obligation).

⁸¹ Because the analysis will change, and the role of the all events test will be diminished, in "nonrecurring" cases governed by the Tax Reform Act of 1984, see *infra* notes 102-60 and accompanying text, limiting *Hughes Properties* and *General Dynamics* to their facts should cause no great harm. Of course, a narrow reading makes the Court's bewildering grant of certiorari even more bewildering. See Jensen, *supra* note 7, at 911-13.

⁸² The strongest feeling tax cases evoke among Supreme Court Justices is often disdain. See *supra* note 8.

The five common members of the two majorities were Justices Brennan, White, Marshall, Powell, and Rehnquist. See *supra* notes 47 & 56. Chief Justice Burger, who dissented in *Hughes Properties*, retired prior to consideration of *General Dynamics*; new Justice Scalia joined the *General Dynamics* majority.

⁸³ Justice O'Connor, who had joined in the *Hughes Properties* majority, authored the *General Dynamics* dissent, concluding that "[i]n my view, the circumstances of this case differ little from those in *Hughes Properties*." *United States v. General Dynamics Corp.*, 107 S. Ct. 1732, 1738 (1987). Certainly the language of an opinion provides little guidance to taxpayers if the author of that language (in this case, Justice Blackmun) has problems with its application so soon after promulgation.

cause GD's claimed deduction greatly exceeded its ultimate reimbursement obligation,⁸⁴ however, the case is more easily seen as involving the second prong of the test, the amount of the claimed liability.⁸⁵

As of the end of taxable year 1972, a year in which medical services had unquestionably been provided to GD employees,⁸⁶ all events had occurred to fix the fact of some liability. GD did not know the precise extent of the obligation at that time. Because not all medical costs were eligible for reimbursement, some claims might have been denied in whole or in part. Furthermore, the plan administrator might later have challenged the legitimacy of some claimed expenses. But an obligation existed with respect to any covered and uncontested claims.⁸⁷ What was uncertain was the

⁸⁴ See *supra* note 45.

⁸⁵ Cf. Bradley & Winslow, *supra* note 4, at 229 (reasonable accuracy requirement provided Service best challenge to deductibility of uncontested, undiscounted future liabilities in worker's compensation cases). In several cases, the Ninth Circuit permitted employers a deduction for the undiscounted amount of future worker's compensation liabilities attributable to employee injuries occurring in the years of deduction. The court held that the fact of injury fixed the fact of liability in each case, and the taxpayers successfully employed aggregate analyses (rather than case-by-case inquiries) to demonstrate the amounts of the claimed liabilities. See, e.g., *Kaiser Steel Corp. v. United States*, 717 F.2d 1304 (9th Cir. 1983); *Crescent Wharf & Warehouse Co. v. Comm'r*, 518 F.2d 772 (9th Cir. 1975). Some courts disfavor aggregate analysis to establish the fact of liability, however. See, e.g., *Supermarkets Gen'l Corp. v. United States*, 537 F. Supp. 759, 762 (D.N.J. 1982); Bradley & Winslow, *supra* note 4, at 224-25; Jensen, *supra* note 3, at 461.

⁸⁶ Medical services had "unquestionably" been provided, that is, if any sort of reasonableness standard applies to the analysis of a corporate group that has 56,000 employees. See *supra* note 65. GD did not necessarily know which employees had received treatment, but the Court had concluded in *Hughes Properties* that the identity of the beneficiary need not be known for a liability to be fixed. See *supra* note 49 and accompanying text. Nevertheless, at oral argument Justice Scalia argued to GD counsel that "you do not know if any medical operation has taken place You are guessing that the claims exist." Quoted in Uhlfelder, *Supreme Court Considers Deductibility of Accrued, But Unpaid, Medical Expenses*, 34 TAX NOTES 200, 200 (1987). See also *Supreme Court: Counsel Argue Accrual of Payments Under Employee Medical Plans*, Daily Rep. for Execs. (BNA) G-7, G-10 (Jan. 14, 1987) (Chief Justice Rehnquist hypothetically questioned whether travel expenses should be deductible "only knowing that somewhere in your vast empire some people will travel without knowing if anyone in fact did travel").

⁸⁷ See *Kaiser Steel Corp. v. United States*, 717 F.2d 1304, 1306 n.3 (9th Cir. 1983) (holding that injury established fact of liability with respect to uncontested worker's compensation claims; not conclusive that employee might recover so

amount of that obligation, and that question had been removed from the Court's scrutiny.⁸⁸

quickly that he would not miss work); *see also* *Wien Consol. Airlines, Inc. v. Comm'r*, 528 F.2d 735, 737 (9th Cir. 1976) (holding that liability is fixed although employee might not survive into subsequent taxable years). The plan administrator might later have wrongfully denied a valid claim, but the company's obligation still would have been fixed at the earlier time.

The administrator was an agent of GD, and the administrator's denial of a claim in the year medical services were performed should have been treated as a contest of the claim by GD. Because a contest generally defeats the fact of a liability, no deduction should have been permitted under these circumstances unless and until GD also paid the disputed claim. *See infra* note 187.

If a contest occurred in a later taxable year, however, the liability remained fixed as of the end of the year in which the services were performed (or, under the Supreme Court analysis, the end of the year in which the claim was filed). Assuming the taxpayer demonstrated the amount of liability with reasonable accuracy, proper tax accounting should have required a deduction in that year. If payment had not yet been made in the year in which GD contested the previously fixed liability, the tax benefit rule would have required an adjustment to GD's self-correcting reserve, effectively constituting an inclusion of the amount previously deducted. The contest would have been an event "fundamentally inconsistent with the premise on which the deduction was initially based." *See Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370, 383 (1983) (inclusionary tax benefit rule).

GD did not reimburse all claims submitted by GD employees. *See supra* note 40. But that too should not have defeated the fact of a liability, and, by treating filing as the critical event, the Supreme Court implicitly agreed. Before an administrator's evaluation, it might have been impossible for a neutral observer to determine exactly what portion, if any, of a particular claim was entitled to reimbursement. Nevertheless, all events had occurred to fix the fact of some liability, even though the extent of that obligation was then not precisely known. *See infra* note 88.

⁸⁸ *United States v. Anderson*, 269 U.S. 422 (1926), the case that gave birth to the all events test, supports this analysis. *Anderson* considered the timing of deduction of a munitions tax that was imposed on 1916 profits but was actually paid by the accrual-basis taxpayer in 1917. The taxpayer established accounting reserves for reasonably expected expenses, including the munitions tax. Because events occurring in 1916 fixed the munitions tax, the Supreme Court required the tax to be deducted in that year. Of course, the taxpayer had not actually calculated the tax as of the last day of the year, and it may have been impossible practically (because of cost, among other things) to make such a theoretically possible calculation.

Similarly, GD could in theory have accumulated all of the information and made all of the calculations about its uncontested reimbursement obligations on the last day of 1972. That it was a practical impossibility to do so should not have been fatal. *Cf. Uncasville Mfg. Co. v. Comm'r*, 55 F.2d 893, 895 (2d Cir. 1932) (Hand, J.) ("All the facts upon which the calculation depended had been fixed before the expiration of the year 1918. . . . The computation was uncertain, but its basis was unchangeable; it was unknown, not unknowable on December

Indeed, the uncertainties about GD's reimbursement obligation necessarily implicated both prongs of the all events test. During oral argument in *General Dynamics*, several Justices suggested that the fact and amount questions may not always be analytically separable.⁸⁹ That line of analysis, if pursued in the Court's opinion, would have led to an interesting reconsideration of the all events test.⁹⁰ Moreover, that analysis would have provided a reasoned basis for distinguishing the results in *Hughes Properties* and *General Dynamics*.⁹¹

The Court did not take a new theoretical step, however. Because of the regulatory language, the all events test has historically been treated as having two distinct components⁹² even though they were not always kept distinct.⁹³ Steadfast to that tradition, the opinion in *General Dynamics* limits itself to the fact of liability issue, and consequently the Court crammed its conclusion into an ill-fitting conceptual box. The Court decided the case on a narrow ground, but failed to advance our understanding of that ground.

C. The All Events Test and Formalism

Both *Hughes Properties* and *General Dynamics* purported to consider only the fact of liability issue, and on that issue the juxtaposition of the two cases is conceptually puzzling. Apparently a court may formulate contingencies on its own that could cause an employee to forgo reimbursement of medical claims, while a court

31, 1918. That is the test"); Crane, *supra* note 36, at 283 ("omniscient presence" could have precisely determined extent of GD's liability at end of 1972).

⁸⁹ See *Supreme Court: Counsel Argue Accrual of Payments Under Employee Medical Plans*, Daily Rep. for Execs. (BNA) G-7, G-9 (Jan. 14, 1987).

⁹⁰ If the Court felt uncomfortable taking a step arguably outside the boundaries of the grant of certiorari, and it still wanted to decide the case, it could have asked for further briefing and argument on this issue.

⁹¹ As the case was presented to the Claims Court, there was no question that, if Hughes had a liability, the payoff indicators accurately measured it. See *supra* text accompanying note 28.

⁹² See *Buckeye Int'l, Inc. v. Comm'r*, 49 T.C.M. (CCH) 376, 383 & n.8 (1984) (describing analytical benefits of "[p]reserving the distinction between the two requirements of the all events test" set out in the Treasury regulations); *Supermarkets Gen'l Corp. v. United States*, 537 F. Supp. 759, 762 (D.N.J. 1982) (rejecting use of aggregate analysis to prove the fact of a liability because "case law does not support an integration of the two prongs of [the all events] test").

⁹³ See Jensen, *supra* note 3, at 458 n.84.

may not engage in similar speculation with respect to the winner of a progressive jackpot. Perhaps there is a principle lurking behind this distinction, or maybe it is an overstatement to refer to the "principles" of the all events test.

Subsections I.B and I.C above criticized the two cases in light of traditional all events test jurisprudence. A more fundamental difficulty confronted the Supreme Court, however, in its attempted reconciliation of the cases. The all events test is at best tangentially relevant to the time value of money, the reason for the controversies over the test's application. A rule of administrative convenience that is intended to facilitate decision-making,⁹⁴ the all events test as applied in these cases increases uncertainty and therefore hinders tax planning.

The government's concern in disputes over the all events test is that the taxpayer, if successful, secures deductions in amounts that exceed the true cost of the liabilities. For example, consider a taxpayer that can demonstrate a fixed, definite liability to pay \$100 in five years for an otherwise deductible expense. If the all events test is met (that is, both the fact and the amount of the liability are fixed), and if no other statutory barrier intervenes,⁹⁵ the taxpayer could deduct currently the entire \$100 without any discounting to reflect the time value of money. Therefore, a liability with a present value of less than \$100 could generate a current deduction equal to the full \$100—a "premature accrual."⁹⁶

A premature accrual arises when a deduction precedes payment (or other satisfaction) of a liability and the deduction is not discounted to reflect that time interval. The all events test by its terms

⁹⁴ Cf. Gunn, *supra* note 3 (when conflict exists between matching principle and administratively manageable timing rules, courts have reasonably deferred to the administrable rules).

⁹⁵ See *infra* notes 102-60 and accompanying text for a discussion of the statutory changes made by the Tax Reform Act of 1984.

⁹⁶ The present value of that future obligation, using a discount rate of 5% compounded semiannually, is \$78.12. That is, if the taxpayer invested \$78.12 today at a 5% after-tax rate of return, it would have the \$100 in five years necessary to satisfy the liability. Other authors have posited extreme cases that produce "cost-free" liabilities, where the tax savings from the accelerated deduction equals or exceeds the true cost of the liability. See, e.g., Johnson, *supra* note 3, at 266; McGown, *Structured Settlements: Deduct Now and Pay Later*, 60 TAXES 251, 251-53 (1982).

is not directed at this discrepancy.⁹⁷ Because the all events test was the governing legal standard, the taxpayers and the government in *Hughes Properties* and *General Dynamics* necessarily couched their arguments in the language of the test.⁹⁸ Nevertheless, the fights were about timing.⁹⁹ The government sought a rationale that would delay satisfaction of the all events test as long as possible; the taxpayers sought an interpretation of the all events test that would accelerate the deductions as much as possible.

The deferral at issue provided a potentially substantial economic benefit in each case. For example, in *Hughes Properties*, one of the slot machines had not paid its progressive jackpot for several years.¹⁰⁰ And, in *General Dynamics*, some of the claims for medical services performed in 1972 were apparently not paid until 1974.¹⁰¹

⁹⁷ Historically the Internal Revenue Service usually took the position that a liability could not be fixed under the all events test until activities were performed that would satisfy the liability. That requirement is very much like the economic performance standard added in the 1984 Act by a Congress newly enlightened about the time value of money. See Jensen, *supra* note 3, at 477, 457-59; *infra* notes 102-15 and accompanying text; see also *supra* note 48 and accompanying text (Supreme Court rejected performance requirement in *Hughes Properties*). But see *infra* note 133 (discussing Rev. Rul. 69-429, 1969-2 C.B. 108, which permitted undiscounted deduction of worker's compensation liability without imposition of performance requirement). The Service was sometimes successful with the argument, sometimes not. When the Service was unsuccessful, it had obviously failed to convince the court that the language of the all events test mandated the performance requirement. See Jensen, *supra* note 3, at 467-68; Note, *supra* note 3, at 201 ("The all events test is blind to the time value of money.").

⁹⁸ The government probably should not have limited its attack on premature accruals to the all events test. Particularly when the time between accrual and payment was long—so that the tax benefit of a current deduction may even have exceeded the cost of the liability—the Service should have been able to argue successfully that the accounting method used did "not clearly reflect income." The Code gives the Commissioner broad authority to require changes in accounting methods. See I.R.C. § 446(b); see also Gunn, *supra* note 3, at 30-32 (government should argue "that an immediate deduction for expenses paid in the future distorts income"). The Service seldom made this argument, however. See *id.*; Jensen, *supra* note 3, at 470-76; Bradley & Winslow, *supra* note 4, at 231. *Mooney Aircraft v. United States*, 420 F.2d 400 (5th Cir. 1969), is a notable case in which the Service successfully pressed a "clear reflection" argument to deny a current deduction for a liability that might not have been satisfied for 30 years; the interval was "too long." 420 F.2d at 409-10.

⁹⁹ The government did argue time value considerations in *Hughes Properties*, but the Supreme Court summarily rejected that argument. See *supra* note 50.

¹⁰⁰ See *supra* note 24 and accompanying text.

¹⁰¹ *General Dynamics Corp. v. United States*, 6 Cl. Ct. 250, 256 (1984). Some

The resolution of these cases under the all events test required discussion about the nature of events—provision of medical services versus filing of claims versus approval of claims—but the discussion lacked any connection to the fundamental timing issue. It was not the nature of the events, but the time of the events in relation to the payment satisfying the taxpayer's liability that was crucial to the economic result in each of the two cases. The Court's fumbling effort to define the last "event" fixing a liability was necessarily formalistic with a test untouched by sophistication about the time value of money. In the Tax Reform Act of 1984, the subject of the next section of this article, Congress tried to provide a theoretical grounding for the all events test.

III. THE 1984 TAX ACT AND PREMATURE ACCRUALS

A. New Section 461(h)

In the 1984 Tax Act, Congress significantly changed the rules governing the timing of deductions by accrual-basis taxpayers. While elevating the all events test from the regulations to the Code,¹⁰² new section 461(h) requires that a deduction generally be taken no earlier than "economic performance" with respect to the liability.¹⁰³

of the lengthier delays may have been due to GD challenges to claims, and those amounts should have been subject to the rules governing contested liabilities. See *supra* note 87. But other delays had other causes, such as employees' failures to file claims on a timely basis.

¹⁰² The new Code provision tracks the language of the regulations: "the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy." I.R.C. § 461(h)(4).

¹⁰³ I.R.C. § 461(h)(1). The Code subjects the economic performance requirement to a potentially important exception for "certain recurring items." A liability will be considered as incurred within a taxable year if four conditions are satisfied:

- (1) the all events test, applied without an economic performance requirement, is satisfied;
- (2) economic performance in fact occurs within a reasonable period after the close of the taxable year (and no later than 8-1/2 months after such close);
- (3) the item is recurring and the taxpayer's treatment is consistent from year to year; and
- (4) either the item is not a material item or accrual in the taxable year results in a "more proper" matching of expenses and income.

As a result, to be entitled to deduct a future obligation in the current taxable year, a taxpayer must now¹⁰⁴ demonstrate not only the fact and the amount of the liability, but also that economic performance has occurred or is occurring.

The nature of the transaction determines the time when economic performance is deemed to occur. For example, economic performance attributable to an obligation to provide or pay for property or services occurs only upon provision of the property or services.¹⁰⁵ Economic performance with respect to a liability arising either under a worker's compensation statute or out of a tort occurs only as payments are made to another person.¹⁰⁶ The Code authorizes the Secretary of the Treasury to provide exceptions to these rules¹⁰⁷ and to define economic performance for cases not specifically covered by the statute.¹⁰⁸

Section 461(h) generally operates to defer deductions beyond the time that they could have been taken under prior law.¹⁰⁹ Indeed,

than would accrual in a later year.

I.R.C. § 461(h)(3)(A). See also Jensen, *supra* note 3, at 480-81. Although the addition of the economic performance requirement diminishes the importance of the all events test, application of the test continues to be of controlling importance in determining availability of the "recurring items" exception.

The "recurring items" exception contains many ambiguities, however, and, "in many if not most of the cases, it will be difficult to determine if the exception is available." Bowers & Stone, *Some Items Still Deductible Under All-Events Test Despite New Economic Performance Rules*, 64 J. TAX'N 354, 356 (1986). For example, how should the second requirement, the 8-1/2 month test, be applied to facts like those of *Hughes Properties* and *General Dynamics*? In those cases, the liabilities were generally, but not always, satisfied within a short period after the end of the year in which the taxpayers claimed deductions. Should compliance with the test be measured on an aggregate basis or by use of a claim-by-claim analysis? See Jensen, *supra* note 7, at 917-18 (discussing this issue).

¹⁰⁴ The changes made by the Tax Reform Act of 1984 are generally effective for deductions that under prior law would have been allowable after July 18, 1984 (the date of enactment of the 1984 Act). Pub. L. No. 98-369, § 91(g)(1), 98 Stat. 494, 608.

¹⁰⁵ I.R.C. §§ 461(h)(2)(A), 461(h)(2)(B).

¹⁰⁶ I.R.C. § 461(h)(2)(C).

¹⁰⁷ I.R.C. § 461(h)(2) (introductory language states "[e]xcept as provided in regulations prescribed by the Secretary").

¹⁰⁸ I.R.C. § 461(h)(2)(D).

¹⁰⁹ See Bowers & Stone, *supra* note 103, at 354. Because it adds a requirement to the all events test, I.R.C. § 461(h) cannot result in deductions earlier than permitted under pre-1984 Act law. If the all events test and the economic performance requirement are satisfied simultaneously, the time of deduction is the same whether pre-1984 Act or post-1984 Act law governs.

Congress added the section to the Code because it perceived that accrual-basis taxpayers had been generating deductions that exceeded the true cost of the corresponding liabilities.¹¹⁰ Return to the example of a taxpayer that has a present, fixed liability to pay \$100 in five years for an otherwise deductible expense.¹¹¹ A current deduction equals the cost of the liability only if the taxpayer is limited to the present value of the future obligation, but until recently neither the Code nor any judicial decision permitted a discounted deduction in such circumstances.¹¹² Under section 461(h), if the future liability is associated with the provision of property or services in year five, the \$100 will not be deductible until that time. In this example, the deduction and the true cost of the obligation will be perfectly meshed at the later date because, "[e]conomically, a present deduction of the present value [of a future obligation] is equivalent to a future deduction of the future value."¹¹³

In their attacks on premature accruals, the changes made by the 1984 Act thus constitute a major improvement over pre-Act law. In other cases, however, the meshing of deduction and cost may not so closely approach perfection. Because the concern with pre-

¹¹⁰ See H.R. REP. NO. 432, 98th Cong., 2d Sess. 1254 (1984) [hereinafter 1984 House Report]; STAFF OF SENATE FINANCE COMM., 98TH CONG., 2D SESS., DEFICIT REDUCTION TAX BILL OF 1984, EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, 271 (Comm. Print 1984) [hereinafter 1984 Senate Report]; STAFF OF JT. COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 260 (Comm. Print 1984) [hereinafter 1984 Blue Book].

¹¹¹ See *supra* notes 95-96 and accompanying text.

¹¹² See *Burnham Corp. v. Comm'r*, 90 T.C. no. 62 (May 11, 1988). Commentators have suggested the appropriateness of such discounting for accrual-basis taxpayers. See, e.g., Aidinoff & Lopata, *supra* note 3, at 811-23; Note, *supra* note 3, at 202-08.

The Code now requires discounting of present deductions (rather than deferral of undiscounted deductions) in certain specialized areas. For example, the Tax Reform Act of 1986 requires that the deduction available to non-life insurance companies for "unpaid losses" be discounted to present value. See I.R.C. § 832(b)(5), as amended by Tax Reform Act of 1986, Pub. L. No. 99-514, § 1022(a), 100 Stat. 2085, 2397-99; I.R.C. § 846, as added by Tax Reform Act of 1986, Pub. L. No. 99-514, § 1023(c), 100 Stat. 2085, 2399-404. See also *infra* notes 167-92 and accompanying text (discussing I.R.C. § 832(b)(5) (1982) as it applied at time of *General Dynamics*).

¹¹³ Bradley & Winslow, *supra* note 4, at 233 (footnote omitted); see Gunn, *supra* note 3, at 31 n.144.

mature accruals is the time lag between deduction and payment (or other satisfaction) of the liability,¹¹⁴ the economic performance requirement corrects the disparity only to the extent that the time of economic performance and payment coincide. A premature accrual, although of reduced economic benefit, remains whenever further time elapses between economic performance and payment. If the taxpayer receives services (and therefore economic performance occurs) in year five but pays the \$100 for the services in year six, the taxpayer will still receive the economic benefit of a deduction that is one year premature under the new statute.¹¹⁵

B. The 1984 Tax Act, Progressive Jackpots, and Medical Self-Insurance Plans: Judicial Misreading of Legislative History

The economic performance requirement did not apply in either *Hughes Properties* or *General Dynamics*.¹¹⁶ At the time the Court considered *Hughes Properties*, the Justices may not have been aware that the statutory changes could affect the analysis of later, similar cases.¹¹⁷ When section 461(h) does apply to such a gambling case, this author has argued elsewhere that the section requires delaying a deduction until the casino pays its prize, the position unsuccessfully advocated by the government in *Hughes Properties*.¹¹⁸ Only when the casino has paid—that is, has provided “property or services” to another person—is the economic performance test met. If this interpretation is correct, and such a result is consistent with what should have been the underlying theory of section 461(h),¹¹⁹

¹¹⁴ See Gunn, *supra* note 3, at 35; Johnson, *supra* note 3, at 264-65.

¹¹⁵ Either the deduction is premature, or the amount of any deduction permitted in year five should be limited to an appropriately determined present value of the future obligation. But see *supra* note 112 and accompanying text. The present value in year five of the obligation to pay \$100 in year six is \$95.18, using a discount rate of 5% compounded semiannually. Cf. *supra* note 96. However, if I.R.C. § 461(h) is applicable, and no other timing rule (such as I.R.C. § 83(h) or I.R.C. § 404(a)(5)) overrides the effect of that section, nothing would preclude the taxpayer's taking a deduction for the full \$100 in year five.

¹¹⁶ See *supra* note 104 (effective date of changes made by 1984 Act); see also *United States v. General Dynamics Corp.*, 107 S. Ct. 1732, 1735-36 n.3 (1987).

¹¹⁷ See Jensen, *supra* note 7, at 911-12.

¹¹⁸ *Id.* at 917.

¹¹⁹ See *supra* notes 114-15 and accompanying text. In private correspondence and discussion, several readers have questioned the conclusion that economic performance occurs only when the prize is won. The critics correctly note that the

the government's position in *Hughes Properties* is the statutorily required result in post-1984 Act casino cases.

By the time of its decision in *General Dynamics*, the Court had become aware that the statute had been modified and that future cases will not be analyzed under the principles of *General Dynamics* alone. Indeed, in a footnote the Court not only acknowledged the recent legislative developments, it also hinted at the effect of those changes:

We do not address how this case would be decided under § 461(h), but note that the legislative history of the Act indicates that, "[i]n the case of . . . employee benefit liabilities, which require a payment by the taxpayer to another person, economic performance occurs as the payments to such person are made."¹²⁰

definitions of economic performance are generally not tied to the time of payment. See *infra* notes 105-08 and accompanying text. Moreover, the Joint Committee Explanation of the Act provides that, for purposes of the rules governing provision of property or services, the term "property" "does not include money." 1984 Blue Book, *supra* note 110, at 262; cf. Treas. Reg. § 1.83-3(e) (money is not "property" for purposes of I.R.C. § 83). But see *infra* note 132 (reduced significance to be given to Blue Book positions that are unsupported by other authority). The critics have suggested accordingly that the casino may be treated as providing "services" each time a player pulls a slot machine handle, increasing the progressive jackpot. The player receives "services," therefore, merely by playing the game. Under this analysis, with economic performance occurring as the machines are played, I.R.C. § 461(h) would not change the result in a case like *Hughes Properties*; the all events test and the economic performance requirement would be satisfied simultaneously.

This is a more than plausible argument. If the progressive jackpot cases must be analyzed under I.R.C. § 461(h), it is difficult to fit their peculiarities definitively within the analytic boundaries of the statute; Congress did not legislate with casino operations in mind. However, the critics' suggested result would be inconsistent with the new section's goal of lessening premature accruals. See W. KLEIN, B. BITTKER, & L. STONE, *FEDERAL INCOME TAXATION* 437 (7th ed. 1987). Reading the statute in light of its purposes favors the result suggested in the prior article. When significant doubt about the time of economic performance remains under the statutory language, a deduction should be deferred until the time of payment (or other satisfaction of the liability) by the taxpayer.

¹²⁰ *United States v. General Dynamics Corp.*, 107 S. Ct. 1732, 1736 n.3 (1987) (quoting 1984 House Report, *supra* note 110, at 1255, and citing H.R. REP. NO. 861, 98th Cong., 2d Sess. 872 (1984) (conference committee explanation of House bill) [hereinafter 1984 Conference Report]).

Thus, in one sentence, the Court did precisely what it purported not to do. It suggested the resolution of a similar case under the new statute.

How well does the Court's gratuitous suggestion stand up to scrutiny? Consider two economically similar cases. If Able performs services for Baker, economic performance is deemed to occur with the performance of the services. Thus, if the all events test is otherwise met by that time, the statute then entitles Baker to a deduction. If, however, Able performs services for an employee of Baker for which Baker is obligated to pay, the Court suggests that economic performance occurs only upon payment. Is there any principle that, from the standpoint of Baker, the party for whom services are being performed directly or indirectly,¹²¹ justifies a different result in the timing of deductions?

Delay of the deduction until payment is consistent with the theory that should have governed section 461(h); such a rule would eliminate premature accruals.¹²² That theory, however, is not consistently reflected in the definitions of economic performance. The statute by its terms permits the deduction of many liabilities before payment occurs,¹²³ and there is nothing peculiar about services provided in connection with "employee benefit liabilities" that necessarily justifies treatment different from the provision of services generally.¹²⁴

¹²¹ Both Baker's employee and the provider of medical services provide services to Baker. See *infra* note 124; note 132 and accompanying text.

¹²² See *supra* notes 114-15 and accompanying text.

¹²³ See *supra* notes 105-06 and accompanying text. The statute defines economic performance as occurring on payment only with respect to worker's compensation and tort liabilities. I.R.C. § 461(h)(2)(C).

¹²⁴ At least there is nothing obviously peculiar about such liabilities, and the Court did not enlighten us about any hidden peculiarities that should have controlling effect. Two possibilities come to mind, but neither persuasively requires reading a payment requirement into the statute.

First, in the employee reimbursement situation, it is unclear from the statutory language whose services are relevant—that is, whether the analytical focus should be on the medical services or on the employee's services to the employer. See W. KLEIN, B. BITTKER & L. STONE, *supra* note 119, at 437 (assuming performance of medical services was controlling). But see *infra* note 135 and accompanying text (conference committee report suggesting economic performance occurs as employee performs services). Whatever uncertainty may exist on this point, however, it provides no reason to delay the deduction until a still later time, the time of

Moreover, the language of section 461(h) does not suggest that medical self-insurance plans should be governed by any principle other than that applicable to "services . . . provided to the taxpayer"; that is, economic performance occurs with the performance of services.¹²⁵ The government could argue that the medical services (assuming those are the critical services for analytical purposes¹²⁶) are not being provided to the "taxpayer," a self-insured employer like GD, but to the employee. Such an argument is formalistic at best. If the services are provided at a taxpayer's expense pursuant to a contract between the taxpayer and its employees, they are being provided for the indirect benefit of the taxpayer-employer.

This leaves no basis for distinguishing the two hypothetical cases involving services, and the Court's suggestion about the effect of section 461(h) is therefore suspect. Although it is perhaps unfair to chastise the Court for not providing a justification grounded in theory on an issue that the Court purported not to have addressed, the failure on this point goes beyond lack of theoretical sophisti-

payment for the medical services. Moreover, the uncertainty will, in nearly all cases, have no practical effect because the two types of services are provided simultaneously. The medical services will be provided to an employee (or family member of an employee) during that person's employment.

Second, in some employer-employee cases, concern may arise over the employer's deduction preceding the inclusion of income by the employee. Some Code provisions seek to ensure "inter-taxpayer matching," deferring a deduction until a corresponding inclusion occurs. See, e.g., I.R.C. § 83(h) (deferring deduction attributable to compensation-related transfer of property until amount is included in gross income of services-provider). With a plan like that in *General Dynamics*, inter-taxpayer matching is not fully implicated, however, because the reimbursement of the medical expenses would generally be excludable from the gross income of the employees. See I.R.C. § 105(b); see also Crane, *supra* note 36, at 282 ("The ultimate recipients of the amounts to be paid by [GD] can be identified, and, if they were all accrual basis taxpayers, they could all be charged with income as a result of the performance of services.").

¹²⁵ I.R.C. § 461(h)(2)(A) provides:

If the liability of the taxpayer arises out of—

- (i) the providing of services to the taxpayer by another person, economic performance occurs as such person provides such services,
 - (ii) the providing of property to the taxpayer by another person, economic performance occurs as the person provides such property,
- or
- (iii) the use of the property by the taxpayer, economic performance occurs as the taxpayer uses such property.

¹²⁶ See *supra* note 124; *infra* note 132 and accompanying text.

cation. The language that the Court quoted from the legislative history applied to a version of the 1984 legislation that was not enacted. Presumably badly advised by its clerks, the Court violated a basic tenet of statutory interpretation: interpretive passages in a congressional committee report should be examined in light of the language that the report is interpreting.

The full language of the committee report, without the Court's artful ellipsis, provides that, "[i]n the case of worker's compensation, tort, and employee benefit liabilities, which require a payment by the taxpayer to another person, economic performance occurs as the payments to such person are made."¹²⁷ That passage interprets language in the House bill that said precisely the same thing, language that applied to the three named categories of liabilities.¹²⁸ But that language did not survive the legislative process intact. During its deliberations, the conference committee deleted the bill's reference to "employee benefit liabilities."¹²⁹ The statutory section as enacted treats "payment" as the event constituting economic performance only for worker's compensation and tort liabilities.¹³⁰

The conference committee report does not explain the deletion of the reference to "employee benefit liabilities." Perhaps the Supreme Court was correct in implying that economic performance and hence deduction of such liabilities should await payment.¹³¹

¹²⁷ 1984 House Report, *supra* note 110, at 1255.

¹²⁸ H.R. 4170, 98th Cong., 2d Sess. § 91(a) (1984), *reprinted in* 1984 House Report, *supra* note 110. In the bill, employee benefits subject to the rules of I.R.C. § 404 (dealing with certain deferred compensation plans), I.R.C. § 404A (dealing with foreign deferred compensation plans), and I.R.C. § 419 (dealing with defined welfare benefit funds) were excepted from the economic performance rules of proposed I.R.C. § 461(h).

¹²⁹ Similar to the House version, the Senate bill defined economic performance as payment to another person for the same three named categories of liabilities. The bill included the same exceptions, *see supra* note 128, and added another: if payments were made within 2-1/2 months after the close of the taxable year, the special rule for "employee benefit liabilities" was not to apply. Thus, in such a case, economic performance would be defined as the time of services, not the time of payment. S. 2062, 98th Cong., 2d Sess. § 71(a) (1984), *reprinted in* 1984 Senate Report, *supra* note 110.

¹³⁰ I.R.C. § 461(h)(2)(C).

¹³¹ *But see infra* notes 136-60 and accompanying text (suggesting proper post-1984 Act analysis). It is true that deferral of a deduction until payment would eliminate the premature accrual effect, and, when there is substantial doubt about the time of economic performance, the legislative language should be interpreted

That is a peculiar inference to draw, however, from Congress' deletion of a phrase that would have unequivocally secured that result. Moreover, the conference committee suggested that economic performance may occur even prior to the provision of medical services, at the time the employee provides services to the employer.¹³²

in a way that reduces premature accruals. *See supra* note 119. But the Court was not making an argument about uncertainty on this issue; it merely quoted language from a questionably relevant committee report as if that language removed any doubt.

¹³² The conference report stated that "economic performance with respect to a liability to an employee generally occurs as the *employee* renders his or her services." 1984 Conference Report, *supra* note 120, at 877 (emphasis added). The Supreme Court had cited to the conference report, *see supra* note 120, as if that report supported its suggestive nonsuggestion about "employee benefit liabilities." However, the page citation is to the conference committee's description of the House bill, not to a discussion of the committee's own product. *See* 1984 Conference Report, *supra* note 120, at 872.

The Joint Committee on Taxation's General Explanation of the Act (the "Blue Book") lends support to the Supreme Court's implication: "Economic performance with respect to employee benefits (other than compensation) occurs generally when the employer makes a payment under the benefit plan (rather than when the services are rendered)." 1984 Blue Book, *supra* note 110, at 267. If the Joint Committee's language purports to explain I.R.C. § 461(h), however, its statutory origin is obscure.

Perhaps the Blue Book language merely means that other statutory sections, such as I.R.C. § 404, *see infra* notes 136-60 and accompanying text, may often defer deductions until payment and thus may have the effect of preempting I.R.C. § 461(h). So interpreted, the language would be less objectionable. An example provided in the Blue Book, however, suggests that the Joint Committee staff intended the language to mean precisely what it says about the time of economic performance. *See* 1984 Blue Book, *supra* note 110, at 267 (contribution to trust under funded welfare benefit plan that, because of effective date of I.R.C. § 419, was not governed by that section, said to be deductible only at time of payment under I.R.C. § 461(h)); *infra* note 138 (describing effect of I.R.C. § 419).

Even if the Joint Committee staff intended the Blue Book language to explain I.R.C. § 461, the language should be given relatively little interpretive weight because it is arguably contrary to the conference committee report. *Cf.* *Bank of Clearwater v. United States*, 7 Cl. Ct. 289, 294 (1985):

It is this court's view that, although said Joint Committee Explanation prepared by the staff does not rise to the level of authority given to legislative history, we do not perceive it as totally worthless or unenlightening. It is common knowledge that the congressional staff of the Joint Committee works very closely with the members of Congress in drafting legislation and undoubtedly has "eyeball knowledge" of the fundamental legislative purpose of a given piece of legislation. Absent

We can only speculate about the reason for the deletion. Perhaps the conference committee determined such a liability is likely to have a sufficiently short "tail"—the time between accrual and payment—and that consequently the economic benefit from an accelerated deduction falls within acceptable limits. In contrast, because worker's compensation and tort liabilities may be discharged in installments over extended periods of time, those liabilities are precisely the kind of potentially abusive liabilities that most concerned commentators.¹³³

Another possible explanation, supported by a great deal of circumstantial evidence, is that the conference committee concluded no special reference to "employee benefit liabilities" was necessary in section 461(h) because other statutory provisions generally determine the timing effect of such liabilities.¹³⁴ Indeed, the committee noted that "an employer's deduction for compensation or other benefits paid to an employee in a year subsequent to economic performance is subject to the rules in the Code . . . governing

any definitive legislative history that is more revealing, the court believes it is proper nonetheless, in the absence of any comparable contrary assertions, to give substantial weight to this Explanation. At the very least, it should receive no less recognition than a thesis of a text writer on a given point.

The Blue Book is a staff-prepared report that neither congressional tax committee reviews; it merely reflects the staff's understanding of congressional intent. See STAFF OF JT. COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 III (Comm. Print 1976).

¹³³ See Bradley & Winslow, *supra* note 4, at 232. In Rev. Rul. 69-429, 1969-2 C.B. 108, the Service had surprisingly ruled that, in the case of a worker's compensation settlement award to be paid in installments over several years, a self-insured employer could deduct the total undiscounted amount of the future awards in the year of settlement. (For example, if the obligation were to pay \$1,000 per year for 10 years, the employer could currently deduct the full \$10,000, rather than the present value of the future stream of payments.) Imaginative planners urged the use of this principle in structuring tort settlements as well. See McGown, *supra* note 96, at 252-53. In certain extreme cases, it was possible to structure a settlement that, because of the value of the current, undiscounted tax deduction, provided an overall economic benefit to the payor. In response to one such example, Professor Gunn remarked, "If this is the law [prior to the 1984 Act], well-advised accrual-method businesses should cancel their liability insurance and run down pedestrians at the rate of at least one a year." Gunn, *supra* note 3, at 26.

¹³⁴ The Supreme Court, in quoting from the House Report, assumed that I.R.C. § 461(h) would control. See *supra* note 120 and accompanying text.

deferred compensation, deferred benefits, and funded welfare benefit plans.¹³⁵ Thus, the committee suggested that even though economic performance is deemed to occur as the employee performs his services (subject, of course, to the Treasury's power to change the rules), other sections may require deferral of the employer's deduction beyond the time of economic performance. Subsection III.C below attempts to locate the analysis of employee benefit liabilities within the new statutory scheme.

C. Timing of Deductions for Employee Benefit Liabilities: Unfunded Medical Reimbursement Plans

The analysis of employee benefit liabilities is enormously complex.¹³⁶ Merely locating the proper analytical starting point in the Code for a particular liability can confuse the very best lawyers.¹³⁷ This article cannot provide the definitive treatise on the deductibility of amounts related to unfunded medical reimbursement plans; it is enough for present purposes to demonstrate the misleading nature of the Supreme Court's suggestion about post-1984 Act law. For those lawyers educated about employee benefits, the Court has added confusion to an already confused area. For inexperienced lawyers, the Court applied a veneer of simplicity to an area that is decidedly not simple.

If a medical reimbursement plan is unfunded¹³⁸ and it provides

¹³⁵ 1984 Conference Report, *supra* note 120, at 877. Accordingly, because the rule defining economic performance as payment does not include employee benefit liabilities, the House and Senate bills' references to I.R.C. §§ 404, 404A, and 419 as exceptions to that rule were unnecessary. See *supra* notes 128-29.

¹³⁶ Subsection III.C of this article can only suggest the necessary complexity. The analysis of medical reimbursement plans provided here assumes the inapplicability of I.R.C. § 83(h) and Treas. Reg. § 1.83-3(e), which apply to compensation-related transfers of "property," not including money; and I.R.C. § 404A, dealing with certain foreign deferred compensation plans.

¹³⁷ The author has read memoranda of major law firms that ignore the effects of some of the potentially crucial Code sections. See also W. KLEIN, B. BITTKER & L. STONE, *supra* note 119, at 437 (also ignoring I.R.C. § 404).

¹³⁸ "Unfunded" means, for this purpose, that the reimbursement obligation will be discharged through use of the employer's general funds and the employer has not taken steps to segregate assets (through separate trusts, bank accounts, and so on) to meet the obligation. Moreover, the analysis in the text assumes that, whatever the nomenclature used by the employer, the tax effects of a reimbursement plan will not be governed by I.R.C. § 419, relating to arrangements that

"deferred benefits," then under section 404¹³⁹ the employer may deduct otherwise deductible¹⁴⁰ amounts only as they are includable

constitute "funded welfare benefit plans." I.R.C. § 419 and its companion provision, I.R.C. § 419A (dealing with qualified asset accounts), were added to the Code by the Tax Reform Act of 1984, Pub. L. No. 98-369, § 511(a), 98 Stat. 494, 854-61, and were amended by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1851, 100 Stat. 2085, 2858-63. If § 419 did apply, the employer would effectively be put on a cash basis, with contributions deductible (subject to some limitations) only as paid to a "welfare benefit fund."

A "welfare benefit fund" is a "fund which . . . is part of a plan of an employer, and . . . through which the employer provides welfare benefits to employees or their beneficiaries." I.R.C. § 419(e)(1). "Welfare benefits," in general, are all benefits other than those governed by I.R.C. § 83(h), I.R.C. § 404, or I.R.C. § 404A. I.R.C. § 419(e)(2); see *supra* note 128 (describing other cited Code sections).

Without a segregated account or fund created specifically to cover the plan's obligations, a reimbursement plan should avoid the application of I.R.C. § 419. Generally, a "fund" is defined as one of several enumerated tax-exempt organizations; a trust, corporation, or other taxable entity; and, "to the extent provided in regulations, any account held for an employer by any person." I.R.C. § 419(e)(3). The legislative history provides some guidance on what constitutes a "fund":

In prescribing regulations relating to the definition of the term "fund," the conferees wish to emphasize that the principal purpose of this provision . . . is to prevent employers from taking premature deductions, for expenses which have not yet been incurred, by interposing an intermediary organization which holds assets which are used to provide benefits to the employees of the employer.

1984 Conference Report, *supra* note 120, at 1155. The House Report indicated in a footnote, however, that "employer contributions to a separate bank account of the employer or to a subsidiary or other related party would not be considered contributions to a fund." 1984 House Report, *supra* note 110, at 1280 n.18.

The analysis can be particularly confusing, and the possibility of application of I.R.C. § 419 therefore correspondingly greater, if the employer interposes a third party administrator, such as an insurance company, for the plan. Temporary regulations have provided that "if an employer makes a payment to an insurance company under an 'administrative services only' arrangement with respect to which the life insurance company maintains a separate account to provide benefits, then the arrangement would be considered to be a 'fund.'" Temp. Treas. Reg. § 1.419-1T, A-3(c). But see Announcement 86-45, 1986-15 I.R.B. 52 (clarifying arrangements with insurance companies that will be classified as "funds").

¹³⁹ I.R.C. § 404 was modified in both 1984 and 1986. The most noteworthy modification for present purposes was the addition of I.R.C. § 404(b)(2). Tax Reform Act of 1984, Pub. L. No. 98-369, § 512(a), 98 Stat. 494, 862-63. See *infra* note 141.

¹⁴⁰ I.R.C. § 404(a) provides, in relevant part, that if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such . . . compensation shall not be deductible under this chapter; but, if they [sic]

in the gross income of employees (or as they would be includable were it not for a statutory exclusion).¹⁴¹ The requirement that the amount "otherwise be deductible" means not only that the expense must be an ordinary and necessary business expense (or have another statutory basis for deduction), but also that the statutory timing requirements must be met. By its terms, section 404 acts only as a deferral provision: when the threshold all events test, as modified by the economic performance requirement, has been satisfied, the employer must consider whether that section requires still further deferral.¹⁴²

Integrating these statutory pieces—the all events test, the economic performance requirement, and section 404—in a simple example may be helpful. Assume that an employee performed services

would otherwise be deductible, they [sic] shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year.

Among the specified limitations is that of I.R.C. § 404(a)(5). *See infra* note 141.

Prior to the Tax Reform Act of 1986, I.R.C. § 404(a) required that the deductions be otherwise available under either I.R.C. § 162 or § 212. The 1986 Act substituted the less restrictive "otherwise be deductible" language. Pub. L. No. 99-514, § 1851(b)(2)(C)(i), 100 Stat. 2085, 2863.

¹⁴¹ I.R.C. § 404(b)(2), as amended by Tax Reform Act of 1984, Pub. L. No. 98-369, § 512(a), 98 Stat. 494, 862-63, requires treating "any plan providing for deferred benefits (other than compensation) for employees . . . as a plan deferring the receipt of compensation," and thus subject to the timing rules of I.R.C. § 404(a). I.R.C. § 404(b)(1) includes in the category of "plan" for this purpose any method or arrangement having the effect of a plan. Section 404(a)(5) in general requires deferring the deduction for an unfunded plan until "the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan." In determining timing, it is irrelevant that medical reimbursement would generally be excludable from the gross income of employees. I.R.C. § 404(b)(2)(A); *see supra* note 124.

Like the economic performance rules, I.R.C. § 404(b)(2), as amended, is generally effective after July 18, 1984, the date of enactment of the 1984 Act. Tax Reform Act of 1984, Pub. L. No. 98-369, § 512(c), 98 Stat. 494, 863; Temp. Treas. Reg. § 1.404(b)-1T, A-3.

Although the analysis herein involves reimbursement plans for employees, I.R.C. § 404(d) in general applies the same timing rules to deferred compensation and deferred benefits provided to independent contractors.

¹⁴² Temp. Treas. Reg. § 1.461(h)-4T provides that, "[i]n the case of an accrual method taxpayer, a contribution or compensation satisfies the requirements of section 162 or 212 [i.e., is deemed to "otherwise be deductible," *see supra* note 140] only to the extent that the all events test . . . and the economic performance requirement . . . are satisfied."

for an accrual-basis employer in 1986, received medical services and filed a claim for reimbursement in 1986, and is reimbursed for the medical costs under the employer's unfunded plan in 1987. Assume also that both the employer and employee have a calendar-year taxable year. The *General Dynamics* Court said the all events test is satisfied upon filing a claim for reimbursement—1986 in this example (if the reasonable accuracy requirement is met at that time).¹⁴³ Under section 461(h), prior to any regulatory modification, economic performance is apparently deemed to have occurred as the employee performed his services, also in 1986.¹⁴⁴ But absent a statutory exclusion rule, the employee, as a cash-basis taxpayer, would have to include the reimbursed amounts in income as received, in 1987. If this plan is a deferred benefits plan,¹⁴⁵ section 404 requires deferring the employer's deduction until 1987, the year of payment, despite apparent compliance with section 461(h) in 1986.

Another consideration reinforces the conclusion that 1987 is the appropriate year of deduction. Notwithstanding the suggestion in the legislative history,¹⁴⁶ the economic performance requirement will not have been met in 1986. Under its statutory authority to modify section 461(h)'s definitions,¹⁴⁷ the Treasury issued temporary regulations defining economic performance, in the case of a deferred benefit that is governed by section 404 and that is received by a cash-basis taxpayer, as the time of payment.¹⁴⁸

The analysis has come full circle. Economic performance, according to the temporary regulations, occurs upon payment. The

¹⁴³ See *supra* notes 55-60 and accompanying text.

¹⁴⁴ See *supra* note 132 and accompanying text.

¹⁴⁵ Certainly the plan is a deferred benefits plan from a common sense perspective because it provides a deferred benefit to the employee who performed the services in 1986 but receives the benefit—the reimbursement—in 1987.

¹⁴⁶ See *supra* note 132 and accompanying text.

¹⁴⁷ See *supra* note 107 and accompanying text.

¹⁴⁸

In the case of a contribution or compensation subject to section 404 . . . , pursuant to the authority under section 461(h)(2), economic performance occurs . . . in the case of a plan subject to section 404, either as the contribution is made under the plan or, if section 404(a)(5) is applicable, as an amount attributable to such contribution is includible in the gross income of an employee

Temp. Treas. Reg. § 1.461(h)-4T, A-1.

Supreme Court's suggestion in *General Dynamics* that the employer's deduction must await the year of payment therefore appears to be correct, although by accident.¹⁴⁹ So interpreted, the economic performance requirement merely leads to a result that section 404 would have provided anyway.¹⁵⁰ Why should we care that the Supreme Court cited an irrelevant piece of legislative history if the citation points us in the right direction? If an unfunded medical reimbursement plan provides deferred benefits to cash-basis employees, a tax planner seems to have no leeway to achieve any acceleration of deductions.

But it is not so simple. We should care about the Court's sloppiness because the Court may well have pointed us in the wrong direction after all. A more detailed statutory map is necessary, and some of the terrain is not yet charted. The above analysis rested on the assumption that a medical reimbursement plan necessarily constitutes a deferred benefits plan.¹⁵¹ Under the temporary regulations, however, and with support in the legislative history,¹⁵² benefits are treated as deferred only if the employee receives the benefits more than a "brief period of time" after the end of the employer's taxable year.¹⁵³ A plan is presumed to defer benefits for more than a brief period only if the employee receives the benefits more than 2-1/2 months after the close of that year.¹⁵⁴

¹⁴⁹ The temporary regulations were promulgated on January 29, 1986, in T.D. 8073, 1986-1 C.B. 65, and thus were available long before the Supreme Court's decision in *General Dynamics*. A citation by the Court to the regulations would have been more helpful than the citation to the House Report.

¹⁵⁰ Even if the "recurring items" exception operates in some cases to treat the all events test as met in the year of filing, without satisfaction of the economic performance requirement, see *supra* note 103, I.R.C. § 404 should defer the deduction until the time of payment for any deferred benefit.

¹⁵¹ See Accounting Periods and Methods 203.031, at 370 (CCH Tax Transactions Library) (T.J. Purcell ed. 1987) (apparently assuming that medical reimbursement plans are governed by deferred benefits rules).

¹⁵² "[T]he conferees intend that payment of bonuses or other amounts within 2-1/2 months after the close of the taxable year in which significant services required for payment have been performed is not to be considered a deferred compensation or deferred benefit plan." 1984 Conference Report, *supra* note 120, at 1160. See also 1984 House Report, *supra* note 110, at 1284 ("brief period" rule); 1984 Blue Book, *supra* note 110, at 805 (to same effect). The Senate version of the bill would have codified the 2-1/2 month standard. See *supra* note 127.

¹⁵³ Temp. Treas. Reg. § 1.404(b)-1T, A-2(a).

¹⁵⁴ Temp. Treas. Reg. § 1.404(b)-1T, A-2(b)(1). The regulatory 2-1/2 month rule

The hypothetical medical reimbursement plan therefore is not necessarily a deferred benefits plan. Suppose the plan required that claims for medical services received in 1986 be filed in time to allow the claims to be paid by March 15 of the following year. In such a case, no benefits were deferred more than a brief period beyond the end of 1986, and section 404 therefore does not apply. The all events test (as modified by the economic performance requirement) alone governs the timing of the employer's deduction. For those claims filed in 1986, the fact of liability was then fixed. If section 404 does not apply to the unfunded plan, the temporary regulations do not specify that economic performance occurs with payment,¹⁵⁵ and the statutory definitions of economic performance would control. Economic performance therefore also occurred in 1986 with the performance of services. Accordingly, the employer would have been entitled to a deduction in that year, even if payment did not occur until 1987.¹⁵⁶

reverted the prior position of the Internal Revenue Service that treated a plan as a deferred compensation or deferred benefits plan only if it deferred a payment more than 12 months after the close of the taxable year in which the employer accrued a liability under the plan. See, e.g., Priv. Ltr. Rul. 82-06-169 (Nov. 17, 1981); Priv. Ltr. Rul. 80-06-067 (Nov. 19, 1979) (citing *New York Seven-Up Bottling Co. v. Comm'r*, 50 T.C. 391 (1968) (severance pay plan held to be deferred compensation plan where it provided employees terminating after more than five years' continuous service with one week's pay for each year of service); *Lundy Packing Co. v. United States*, 302 F. Supp. 182 (C.D.N.C. 1969), *aff'd per curiam*, 421 F.2d 850 (4th Cir. 1970) (sick pay plan held to be deferred compensation plan where it entitled employee to one week's pay per year when unable to work or upon termination of employment)); see also Letter from Calvin Johnson to David Brockway (July 2, 1985), reprinted in 28 TAX NOTES 920 (1985) (criticizing vagueness of definition of "deferred" (prior to issuance of temporary regulations) and resultant possibility of planning severely premature accruals).

The temporary regulations merely create a presumption. If the employer provides benefits outside the 2-1/2 month period, the employer may seek to demonstrate that the benefits were nonetheless provided within a "brief period of time." To rebut the presumption, the employer must show that it was impracticable, either administratively or economically, to avoid the further deferral and that, as of the end of the taxable year, the impracticability was unforeseeable. Temp. Treas. Reg. 1.404(b)-1T, A-2(b)(2).

¹⁵⁵ See *supra* note 148 and accompanying text.

¹⁵⁶ It may seem perverse that this analysis results in allowing an employer an earlier deduction, in some circumstances, for an unfunded plan than it would be entitled to for a contribution to a "funded welfare benefit plan." See *supra* note 148 (I.R.C. § 419 defers such a deduction until year of payment to fund). Nonetheless, perversity and the Code are not mutually exclusive.

Consider another real world assumption. Suppose the plan did not require that all reimbursements attributable to 1986 medical services be made by March 15, 1987. Perhaps, in the interest of labor harmony, the employer wished to honor late claims.¹⁵⁷ The plan thus provided deferred benefits, but not all of the benefits were deferred. Many claims were in fact paid by the end of the 2-1/2 month period, but others were not.¹⁵⁸ Is the overall medical reimbursement plan now simply a deferred benefits plan, so that section 404 governs the deductibility of all reimbursed claims under the plan? Perhaps instead the plan should be bifurcated, with those claims for 1986 expenses paid by March 15, 1987, potentially deductible in 1986, and those claims paid after that date treated as deferred benefits, deductible only upon payment. Although the answer is not totally clear under the temporary regulations, it appears that bifurcation is appropriate.¹⁵⁹

The Supreme Court did mislead us.¹⁶⁰ Classification of a liability as an "employee benefit liability" merely begins a complex analy-

¹⁵⁷ GD honored late claims. See *supra* note 64.

¹⁵⁸ Under such circumstances it does not appear possible to rebut the presumption that the employer paid the benefits outside the "brief period." At the end of 1986, it would have been foreseeable that such late payments were to be made. See *supra* note 154.

¹⁵⁹ Certainly a strong argument can be made that bifurcation is appropriate or even that each employee should be treated as having his own "plan." The temporary regulations provide that "[b]enefits are 'deferred benefits' if, assuming the benefits were cash compensation, such benefits would be considered deferred compensation." Temp. Treas. Reg. § 1.404(b)-1T, A-2(b)(1). And the regulations provide a relevant example of a cash arrangement that potentially results in deferred compensation but the status of which is determined employee-by-employee:

[S]alary or a year-end bonus received beyond the applicable 2-1/2 month period by one employee shall be presumed to constitute payment under a plan, or method or arrangement, deferring the receipt of compensation for such employee even though salary or bonus payments to all other employees are not similarly treated because they are received within the 2-1/2 month period.

Id.

In summary, the following table outlines the tax treatment for claims arising from medical services provided in 1986:

<i>Filing of Claim</i>	<i>Payment of Claim</i>	<i>Deductible</i>
1986	Before 3/15/87	1986 (not a deferred benefit)
1986	After 3/15/87	1987 (upon payment)
1987	Any time in 1987	1987 (all events test not met until filing)

¹⁶⁰ The misled included the preparers of the Newsletter of the American Bar

sis, an analysis full of uncertainties. Those uncertainties render the Court's suggestion in *General Dynamics* particularly inappropriate. The treatment of unfunded medical reimbursement plans under post-1984 Act law should not have been discussed in the *General Dynamics* opinion. The Court prides itself on leaving issues not before it for another day, and the Court demonstrated nothing but the wisdom of its usual policy of restraint by offering its gratuitous advice in this case.

IV. THE INSURANCE COMPANY ANALOGY AND THE TREATMENT OF ADDITIONS TO RESERVES

A. Generally

The briefs filed in *General Dynamics* devote a great deal of space to sparring over the proper tax treatment of accounting reserves created to meet future liabilities.¹⁶¹ Despite the controversy, one principle remains clear and undisputed: the fact that generally accepted financial accounting principles may dictate the creation of a reserve in certain circumstances does not, by itself, justify a tax deduction for additions to such a reserve. The Court in *General Dynamics* reiterated that long-accepted principle.¹⁶² To be currently deductible, the liability must be established by facts occurring within the taxable year, without regard to financial accounting treatment.¹⁶³

Association's Section of Taxation. In reporting on the decision in *General Dynamics*, the Newsletter took the Court's suggestion about the time of economic performance at face value. 6 A.B.A. SEC. TAX'N NEWSL. 62-63 (1987).

¹⁶¹ Brief for the United States at 14-47, *United States v. General Dynamics Corp.*, 107 S. Ct. 2092 (1987) (No. 85-1385); Brief for the Respondents at 39-43, *General Dynamics* (No. 85-1385); Reply Brief for the United States at 8-9, *General Dynamics* (No. 85-1385).

¹⁶² *General Dynamics*, 107 S. Ct. at 1737. "The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions." *Lucas v. American Code Co.*, 280 U.S. 445, 452 (1930) (Brandeis, J.) (footnote omitted).

¹⁶³ Financial accounting and tax accounting serve different purposes. "The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled." *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 542 (1979). Financial accounting is thus conservative, tending to depress rather than inflate profits. See Jensen, *supra* note 3, at 475-76. In contrast, the Commissioner's interest is not well-served by using conservative principles to measure income subject to tax. *Thor Power Tool*, 439 U.S. at 542.

Thus, in the classic 1934 case, *Brown v. Helvering*,¹⁶⁴ the Court held that an insurance agent's "obligation" to refund a portion of his commission upon the cancellation of any policy was contingent because of the possibility that no policies would be cancelled. Accordingly, the agent could not deduct the refund obligation prior to the time of a cancellation, even though the agent could predict future cancellations with a relatively high degree of statistical precision and establish an actuarially acceptable reserve to cover the future liabilities.

Some Code provisions expressly permit accrual-basis taxpayers to deduct additions to reserves without regard to the all events test.¹⁶⁵ If Congress was specific about these deductions, should one infer that Congress intended that other, arguably similar additions to reserves not be deductible? The *General Dynamics* Court thought so; it found particularly relevant the Code provisions governing the taxation of certain insurance companies.¹⁶⁶ Sections 832(b)(5)¹⁶⁷ and

¹⁶⁴ 291 U.S. 193 (1934). The Supreme Court cited *Brown* approvingly in both *Hughes Properties* and *General Dynamics*. *United States v. Hughes Properties, Inc.*, 476 U.S. 593, 602 (1986); *General Dynamics*, 107 S. Ct. at 1736-37.

¹⁶⁵ See, e.g., I.R.C. § 585, as amended by Tax Reform Act of 1986, Pub. L. No. 99-514, § 901(a), 100 Stat. 2085, 2375-78 (permitting deduction for reasonable addition to reserves for bad debts of small banks, despite general rule of I.R.C. § 166(a) permitting deduction for bad debts only at time of full or partial worthlessness); see also I.R.C. § 461(h)(5)(C), as amended by Tax Reform Act of 1986, Pub. L. No. 99-514, § 805(c)(5), 100 Stat. 2085, 2362 (economic performance rule not to apply to Code sections specifically providing for deductions for reserves for estimated expenses); I.R.C. § 463(a), prior to repeal by Revenue Act of 1987, Pub. L. No. 100-203, § 10201(a), 101 Stat. 1330-382, 1330-387 (permitting deduction for "reasonable addition to an account representing the taxpayer's liability for vacation pay earned before the end of the taxable year and paid during the taxable year or within 8-1/2 months following the close of the taxable year," specifically including "amounts which, because of contingencies, would not (but for this section) be deductible under section 162(a) as an accrued expense").

¹⁶⁶ In the years in issue, sections 831 through 835 (then part III of Subchapter L) generally applied to every insurance company other than life and mutual insurance companies. See I.R.C. § 831 (1982), prior to amendment by Tax Reform Act of 1986, Pub. L. No. 99-514, § 1024(a)(4), 100 Stat. 2085, 2405-06.

¹⁶⁷ Prior to amendment by the Tax Reform Act of 1986, see *infra* note 169, I.R.C. § 832(b)(5) provided, in general, that "losses incurred" on insurance contracts is computed as follows:

(A) to losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year and deduct salvage and reinsurance recoverable outstanding at the end

832(c)(4),¹⁶⁸ as then in effect,¹⁶⁹ allowed non-life insurance companies¹⁷⁰ to deduct "incurred but not reported" (IBNR) claims, claims precisely like those at issue in *General Dynamics*.¹⁷¹ But GD was not an insurance company,¹⁷² and the Court concluded that, "[i]f the 'all events' test permitted the deduction of an estimated reserve representing claims that were actuarially likely but not yet reported, Congress would not have needed to maintain an explicit provision that insurance companies could deduct such reserves."¹⁷³

of the taxable year.

(B) to the result so obtained, add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year.

I.R.C. § 832(b)(5) (1982).

¹⁶⁸ Section 832(c)(4), unamended by subsequent legislation, permits an insurance company other than a life insurance company to deduct, among other things, "losses incurred," as defined in I.R.C. § 832(b)(5), in computing its taxable income.

¹⁶⁹ The Tax Reform Act of 1986 amended I.R.C. § 832(b)(5) to limit an insurance company's deduction for future unpaid losses to the discounted present value of such losses. I.R.C. § 832(b)(5), as amended by Tax Reform Act of 1986, Pub. L. No. 99-514, § 1022(a), 100 Stat. 2085, 2397-99; see also I.R.C. § 846, as added by Tax Reform Act of 1986, Pub. L. No. 99-514, § 1023(c), 100 Stat. 2085, 2399-2404 (defining "discounted unpaid losses").

¹⁷⁰ "Non-life insurance company" is an inartful term used here to refer to an insurance company that is not a life insurance company. It is not intended to suggest the policies available from participants in organized crime.

¹⁷¹ Taxpayers that are not insurance companies may not rely on the insurance company deduction principles even if the claimed deductions are conceptually identical to those allowed such companies. See *Brown v. Helvering*, 291 U.S. 193, 201 (1934) ("The simple answer [to a taxpayer argument based on insurance company principles] is that the [taxpayer] is not an insurance company"). But the Supreme Court's statement in *Brown* was directed at a reserve for events that had not yet occurred (the cancellation of policies), see *supra* text accompanying note 164; the additions could not be deducted because the all events test had not been met. In contrast, GD's claimed deduction related to events that had already occurred. The deduction was claimed not because the deduction was like that available to insurance companies, but because the all events test had arguably been satisfied.

¹⁷² In fact, the two insurance companies from which GD took over the insurance function had been properly deducting amounts reflecting IBNR claims. *United States v. General Dynamics Corp.*, 107 S. Ct. 1732, 1737 n.6 (1987) (citing *General Dynamics Corp. v. United States*, 6 Cl. Ct. 250, 252 (1984)).

"Self-insurance" is not insurance, as that term is generally understood, because self-insurance does not involve risk-shifting. See *Steere Tank Lines, Inc. v. United States*, 577 F.2d 279, 280 (5th Cir. 1978), cert. denied, 440 U.S. 546 (1979); *supra* note 36.

¹⁷³ *General Dynamics*, 107 S. Ct. at 1737 (footnote omitted).

Two related points may be encompassed by the Court's language. First, the Court unquestionably determined that insurance company tax rules are relevant to the consideration of self-insurance reserves created by non-insurance companies. Second, *General Dynamics* may also be read as addressing a more general issue, the deductibility of any additions to reserves absent specific statutory authority.¹⁷⁴ The Court quite properly did not state that such additions are necessarily not deductible. The opinion's misguided references to insurance company taxation, however, and the Court's failure to specifically repudiate the government's broad arguments on this issue, unnecessarily add to the existing confusion in this area.

B. The Relevance of Insurance Company Taxation

Insurance company taxation is a highly specialized field. In most respects, Subchapter L of the Internal Revenue Code is a self-contained body of law.¹⁷⁵ Accordingly, inferences and analogies from Subchapter L should be drawn only with care, supported by an examination of the purpose and history of the insurance company provisions. The reader of *General Dynamics*, however, searches in vain for a discussion of the legislative history of the relevant insurance tax provisions. The Court does not point to a single passage that discusses the peculiar problem of deductions for additions to insurance company reserves to cover IBNR claims, yet it con-

¹⁷⁴ If specific statutory authority exists, the taxpayer clearly does not need to be concerned about the all events test and economic performance. See I.R.C. § 461(h)(5), as amended by Tax Reform Act of 1986, Pub. L. No. 99-514, § 805(c)(5), 100 Stat. 2085, 2362, and Revenue Act of 1987, Pub. L. No. 100-203, § 10201(b)(5), 101 Stat. 1330-382, 1330-387.

¹⁷⁵ For a history of insurance company (particularly life insurance company) taxation, see *Alinco Life Ins. Co. v. United States*, 373 F.2d 336, 345-48 (Ct. Cl. 1967). The difficulty in measuring an insurance company's income under principles applicable to other taxpayers arises because much of what an insurance company receives in premiums is actuarially, and statutorily, committed to cover valid claims. See *Bituminous Cas. Corp. v. Comm'r*, 57 T.C. 58, 77 (1971), *acq. in result* 1973-2 C.B. 1. In this respect, Hughes' tax situation was analogous to the insurance company model: how (and when) is Hughes' taxable income measured when much of what Hughes received it was required to pay out? See *United States v. Hughes Properties Inc.*, 476 U.S. 593, 606 ("[Hughes'] true income from its progressive slot machines is only that portion of the money gambled which it is entitled to keep"); see also W. KLEIN, B. BITTKER & L. STONE, *supra* note 119, at 437 (suggesting that *Hughes Properties* could be analyzed as a timing of income inclusion case rather than as a deduction case).

cludes that the insurance tax provisions are relevant to consideration of self-insurance reserves created by non-insurance companies.

Perhaps Congress enacted sections 832(b)(5) and 832(c)(4) for reasons other than those suggested by the *General Dynamics* Court. A more limited inference can certainly be drawn from the structure and history of the Code. In 1972, the year in issue, the Code required that life insurance companies employ an accrual method of accounting.¹⁷⁶ The Code sections dealing with other insurance companies contained no such mandate. One group of commentators concluded that "[t]he formula for deducting property and liability company losses incurred demonstrates that they operate under a hybrid method of accounting"¹⁷⁷—a method of accounting that is in part, but only in part, an accrual method.

The statutory starting point for computing "gross income" for non-life insurance companies is the "annual statement approved by the National Association of Insurance Commissioners."¹⁷⁸ Deviations from annual statement principles are few; no judicial decision "stands for the proposition that general provisions appearing elsewhere in the Internal Revenue Code may be used to modify the Annual Statement method of computing underwriting income."¹⁷⁹ So understood, sections 832(b)(5) and 832(c)(4) provide guidance not about the usual rules governing accrual methods of accounting, but about a method of tax accounting that is sui generis. As the Tax Court concluded in *Bituminous Casualty Corp. v. Commissioner*,¹⁸⁰ the all events test is "inconsistent with tax accrual rules applicable to commerce generally."¹⁸¹ Thus, insurers have been held not to be bound by the all events test.¹⁸²

¹⁷⁶ I.R.C. § 818(a) (1982), prior to amendment by Tax Reform Act of 1984, Pub. L. No. 98-369, § 211(a), 98 Stat. 494, 752. The principle is now included in I.R.C. § 811(a).

¹⁷⁷ G. LENROW, R. MILO & A. RUA, *FEDERAL INCOME TAXATION OF INSURANCE COMPANIES* 175 (3d ed. 1979). The Code permits hybrid methods of accounting, methods that contain aspects of both cash and accrual accounting. See I.R.C. §§ 446(c)(3), 446(c)(4).

¹⁷⁸ I.R.C. § 832(b)(1)(A).

¹⁷⁹ *Bituminous Cas. Corp. v. Comm'r*, 57 T.C. 58, 80 (1971), *acq. in result* 1973-2 C.B. 1; see also Rev. Rul. 73-302, 1973-2 C.B. 220 (discussing rationale for acquiescence).

¹⁸⁰ 57 T.C. 58 (1971), *acq. in result* 1973-2 C.B. 1.

¹⁸¹ *Id.* at 78.

¹⁸² *Id.* at 77 ("The deduction of these loss . . . items is fundamentally at odds

Of course, to conclude, as the Tax Court did, that insurance companies are not bound by the all events test does not prove that the Supreme Court's inference in *General Dynamics* is wrong. An argument can be marshalled—and the government implicitly made the argument in its opening brief in *General Dynamics*¹⁸³—that the language of *Bituminous Casualty Corp.* supports the Court's inference. The argument takes the following form: Accrual-basis taxpayers, including insurance companies, are generally bound by the all events test. Because Congress decided that insurance companies should take deductions for IBNR claims, although those claims are inconsistent with the test, it made special statutory provision for the only class of accrual-basis taxpayer permitted to take such deductions.¹⁸⁴

That reading of *Bituminous Casualty Corp.*, however, is supportable only if sections 832(b)(5) and 832(c)(4) are directed specifically at IBNR claims and at nothing else. Even assuming arguendo that the sections would not exist if insurance companies could take only those deductions available to accrual-basis taxpayers generally and that insurance companies may properly deduct IBNR claims,¹⁸⁵ it does not follow that deductions for IBNR claims are unavailable to other accrual-basis taxpayers.

with the 'all events' test"); *id.* at 82 n.2 (Rev. Rul. 67-225, 1967-2 C.B. 238, is wrong because "it seeks to apply an 'all events' test to insurance liabilities in a manner inconsistent with the intent of Congress, the Treasury regulations, and established industry practice"); see G. LENROW, R. MILO & A. RUA, *supra* note 177, at 62.

¹⁸³ Brief for United States at 30-31, *United States v. General Dynamics Corp.*, 107 S. Ct. 1732 (1987) (No. 85-1385).

¹⁸⁴ It was argued that insurance companies may deduct liabilities meeting the all events test plus other liabilities, and the IBNR claims were in the latter category. *Cf. Bituminous Cas. Corp.*, 57 T.C. at 83 (Commissioner's position would, without authority, "construe the word 'liability' . . . as including only items which satisfy the 'all events' test"); see also *id.* at 85 ("it is specifically contemplated that deductions are allowable for dividends which have not accrued under the 'all events' test").

¹⁸⁵ Perhaps we should further assume that it makes sense to try to determine congressional intent associated with one technical tax concept (incomprehensible to most members of Congress) by reference to another, equally incomprehensible technical provision hidden in the massive Internal Revenue Code.

The two sections permit insurance companies to deduct amounts that could not meet the all events test under any reading,¹⁸⁶ such as contested (and unpaid) liabilities¹⁸⁷ and certain liabilities attributable to events that will occur in the future.¹⁸⁸ Thus, sections 832(b)(5) and 832(c)(4) have purposes not necessarily limited to the type of IBNR claims at issue in *General Dynamics*. Perhaps those IBNR claims belong in the category of liabilities deductible by insurance companies but not by others, and the Supreme Court summarily came to that conclusion. But neither statutory language nor logic requires that result. Insurance companies may deduct additions to IBNR reserves, and insurance companies may deduct liabilities that do not meet the all events test, but those two categories are not necessarily coextensive.¹⁸⁹

The Court, quite simply, was wrong in inferring from section 832 that only insurance companies may deduct additions to reserves for IBNR claims. The extent of the Court's error is even more

¹⁸⁶

[T]he major deductions from income are "losses" and "loss adjustment expenses," which are . . . estimated amounts. The deduction of these loss and loss adjustment expense items is fundamentally at odds with the "all events" test: The items include amounts for liabilities which are not established, but, on the contrary, vigorously contested; they include . . . expenses which will not only be paid in the future, but which are attributable to events which will not even occur until the future, including future overhead; and they are so unsusceptible of accurate estimate

Bituminous Cas. Corp. v. Comm'r, 57 T.C. 58, 77-78 (1981), *acq. in result* 1973-72 C.B. 1.

¹⁸⁷ When a taxpayer contests a liability, the contest creates the contingency that negates the fact of liability. See *Lucas v. American Code Co.*, 280 U.S. 445 (1930). The Code now provides limited relief for taxpayers with contested liabilities. A contested liability may be deducted by an accrual-basis taxpayer prior to resolution of the contest if the liability would otherwise be deductible and the taxpayer has actually paid the liability. I.R.C. § 461(f). If the liability has been paid, there is no interval between accrual and payment and hence no premature accrual. See *supra* notes 95-97 and accompanying text.

¹⁸⁸ See *supra* note 186.

¹⁸⁹ Insurance companies may deduct (1) liabilities satisfying the all events test, and (2) other liabilities that do not satisfy the all events test. One cannot infer from the statutory scheme—and from knowing that IBNR claims are deductible—in which of the two categories IBNR claims fit. One also cannot infer that all of the items classified as "IBNR claims" necessarily fit within only one of the two categories.

apparent upon a reexamination of one of the analytical concessions made earlier. We had assumed *arguendo* that sections 832(b)(5) and 832(c)(4) would not exist if insurance companies could take only those deductions available to accrual-basis taxpayers generally.¹⁹⁰ That assumption, however, is inconsistent with the Court's resolution of *General Dynamics*.

Insurance companies may deduct amounts attributable to "unpaid losses,"¹⁹¹ and that statutory category (as its name suggests) includes losses for claims that have already been filed. Because Congress expressly permitted insurance companies to deduct amounts relating to filed but unpaid claims, would the Court have us infer that no other taxpayers may take such deductions? The Court itself drew no such inference; it concluded that GD's failure with respect to filed but unpaid claims was not that such claims are deductible only to insurance companies, but that GD had not created the record to justify its deduction.¹⁹² If GD had provided the data, it would have been entitled to a deduction, *just like an insurance company*. Whatever virtues the opinion in *General Dynamics* has, internal consistency is not among them.

C. The Relevance of Other Reserve Provisions

The Supreme Court in *General Dynamics* made one mistake in concluding that specific insurance company tax provisions were relevant to non-insurance companies. That error is, however, a narrow one. A more important concern is that *General Dynamics* may be read uncritically to stand for the broader principle that additions to reserves are deductible under the all events test only when permitted by specific statutory authority.

The Internal Revenue Code of 1954, as enacted, contained a provision, section 462, that expressly permitted an accrual-basis taxpayer to deduct "reasonable additions" to reserves for estimated expenses related to a trade or business. Congress added section 462 and a companion provision permitting deferral of prepayments received by accrual-basis taxpayers (section 452)¹⁹³ in an express at-

¹⁹⁰ See *supra* text accompanying note 185.

¹⁹¹ See *supra* note 167.

¹⁹² See *United States v. General Dynamics Corp.*, 107 S. Ct. 1732, 1737 (1987); *supra* notes 56-60 and accompanying text.

¹⁹³ For an accrual-basis taxpayer, time of receipt is ordinarily not controlling

tempt to harmonize tax accounting and financial accounting.¹⁹⁴ Within a year of enactment, however, Congress repealed both sections retroactively.¹⁹⁵

Congress intended the repeal of section 462 to deny taxpayers some deductions that otherwise would have been available on an accelerated basis under the short-lived statute. The legislative history clearly evidences concern on the part of Congress and the Treasury about the effect of the section on the revenue.¹⁹⁶ But does the repeal mean that additions to any reserves are deductible only with express statutory authority? The government in *General Dynamics* so argued. In fact, the government's argument in its opening brief went far beyond what was necessary to resolve the case in its favor.¹⁹⁷ In addition, the Tax Court has concluded, in light

for purposes of determining time of income inclusion. However, in three cases decided after the repeal of I.R.C. § 452 (1954), the Supreme Court concluded that payments received before the amounts have been earned must generally be included in income at the time of receipt. This result follows even though it is inconsistent with the generally accepted financial accounting principles described in note 13 *supra*. See *Schlude v. Comm'r*, 372 U.S. 128 (1963) (prepayments for dancing lessons); *American Auto. Ass'n v. United States*, 367 U.S. 687 (1961) (prepayments of membership dues); *Automobile Club v. Comm'r*, 353 U.S. 180 (1957) (prepayments of membership dues); see also Malman, *Treatment of Prepaid Income — Clear Reflection of Income or Muddied Waters*, 37 TAX. L. REV. 103, 105 (1981).

¹⁹⁴ H.R. REP. NO. 293, 84th Cong., 1st Sess. 2-5 (1955), reprinted in 1955-2 C.B. 852, 853-55 [hereinafter 1955 House Report, with page citations to the Cumulative Bulletin]; S. REP. NO. 372, 84th Cong., 1st Sess. 3-6, reprinted in 1955-2 C.B. 858, 859-60 [hereinafter 1955 Senate Report, with page citations to the Cumulative Bulletin].

¹⁹⁵ Ch. 143, §§ 1(a)-(b), 69 Stat. 134, 134 (1955).

¹⁹⁶ *American Auto. Ass'n v. United States*, 367 U.S. 687, 695 (1961); 1955 House Report, *supra* note 194, at 853-55; 1955 Senate Report, *supra* note 194, at 859-60; *Prepaid Income and Reserves for Estimated Expenses: Hearings on H.R. 4725 Before the House Comm. on Ways and Means*, 84th Cong., 1st Sess. 3 (1955) (statement of Treasury Secretary Humphrey).

¹⁹⁷ See, e.g., Brief for the United States at 21, *United States v. General Dynamics Corp.*, 107 S. Ct. 1732 (1987) (No. 85-1385):

Congress thus has specifically considered and, upon reconsideration, rescinded a provision that would have allowed tax deductions for reserves established in accordance with generally accepted financial accounting principles. And there can be no doubt that the . . . reserve for which [GD] seeks a deduction here is precisely the sort of reserve that Congress had in mind in 1954. The Claims Court . . . recognized that it was an ordinary reserve. . . . Indeed, the IBNR account was

of the repeal, that there are few circumstances under which additions to reserves "for liabilities to be incurred in the future" should be deductible:

The repeal . . . removed the only provision providing, in general, for the deduction of estimates of expenses to be incurred in the future. While prudent accounting or financial practices may dictate the establishment of reserves . . . , [such] reserves are not ordinarily deductible.¹⁹⁸

On the other hand, section 462 expressly applied only to items for which no other statutory basis for deduction existed.¹⁹⁹ Additions to reserves that would have been deductible under other principles should have remained deductible after the repeal.²⁰⁰ Additions

literally taken off the books of the insurance companies, where it was indubitably a reserve, and placed upon [GD's] own books.

It may well be that this expansive language, which suggests that characterization as a reserve necessarily destroys deductibility, was intended not as an accurate description of theory, but as part of the expected excesses of advocacy. In its Reply Brief, the government retreated somewhat and agreed that taxpayers may deduct additions to reserves representing already accrued expenses. Reply Brief for the United States at 9, *General Dynamics* (No. 85-1385).

¹⁹⁸ *World Airways, Inc. v. Comm'r*, 62 T.C. 786, 801 (1974). See *Simplified Tax Records, Inc. v. Comm'r*, 41 T.C. 75, 81 n.6 (1963) (repeal of § 462 indicates that Commissioner's discretion in disallowing deduction will be disturbed only if "clear abuse"). Cf. *American Auto. Ass'n v. United States*, 367 U.S. 687, 695-96 (1961) (repeal of § 452 demonstrates congressional disapproval of deferral of prepayments: "the cold fact is that [Congress] repealed the only law incontestably permitting the practice upon which the [taxpayer attempting to defer the inclusion of already received income] depends"). The Tax Court has expressed its concern that excessively loose construction of the all events test would result in the judicial "reenactment" of the repealed § 462. *Ohio River Collieries Co. v. Comm'r*, 77 T.C. 1369, 1377-78 (1981).

¹⁹⁹ The statute generally permitted the deduction of "a reasonable addition to each reserve for estimated expenses." I.R.C. § 462(a) (1954). Included in the definition of "estimated expenses" was a requirement that the deduction be one "part or all of which would (but for this section) be required to be taken into account for a subsequent taxable year." I.R.C. § 462(d)(1)(A) (1954). The deduction was also required to be one "attributable to the income of the taxable year or prior taxable years for which an election under [I.R.C. § 462] is in effect; and . . . which the Secretary . . . is satisfied can be estimated with reasonable accuracy." I.R.C. §§ 462(d)(1)(B), 462(d)(1)(C) (1954).

²⁰⁰ See *Kaiser Steel Corp. v. United States*, 717 F.2d 1304, 1308 (9th Cir. 1983) (rejecting government's argument that estimates reflected in additions to reserves should never be deductible); 1955 Senate Report, *supra* note 196, at 861 ("exten-

to reserves for liabilities yet to be incurred may not be "ordinarily deductible," but the controlling question is whether the requirements of the all events test (now as modified by the economic performance requirement) have been fulfilled.²⁰¹

If the requirements of the all events test are met (with or without the economic performance requirement, as appropriate), then the liability, by definition, is not one "to be incurred in the future." The liability constitutes an "incurred" liability, hence deductible by an accrual-basis taxpayer, even though it may be paid in a subsequent taxable year. If there had been any doubt on that point, the Supreme Court seemed to resolve it in a *Hughes Properties* footnote by denying that any particular significance should be attached to the repeal of sections 452 and 462.²⁰²

The issue should never be whether a particular accounting mechanism creates a "reserve" or not. In the Tax Court's words, "Simply using the term ['reserves'] to describe the deductions in issue is insufficient."²⁰³ A "reserve" is merely an accounting entry,²⁰⁴ and one may be established to cover expenses that are clearly deductible. For example, a reserve may be established to fund an obligation to pay for deductible services that have already been provided and for which the provider has made a claim for payment. In such a case, economic performance has occurred, and,

sion of principles [of *Pacific Grape Prods. Co. v. Comm'r*, 219 F.2d 862 (9th Cir. 1955), described in Jensen, *supra* note 3, at 474] might well lead the courts in the future to permit the accrual of most estimated expenses which would be covered by section 462 even though this section is repealed"); Aidinoff & Lopata, *supra* note 3, at 810; Gunn, *supra* note 3, at 29; McGown, *supra* note 96, at 260; Stanger, Vander Kam, & Polifka, *supra* note 13, at 421. The Claims Court opinion in *General Dynamics* is consistent: "We think that the 1954 enactment and 1955 repeal of § 462 operates [sic] to reestablish the 'all events' test as the appropriate standard for ordinary taxpayers to meet." *General Dynamics Corp. v. United States*, 6 Cl. Ct. 250, 256 n.2 (1984). See also Schlude v. Comm'r, 372 U.S. 128, 139-40 (1963) (Stewart, J., dissenting) (no inference of disapproval of accrual accounting principles to be drawn from repeal of sections 452 and 462).

²⁰¹ See *supra* note 200.

²⁰² "The fact that Congress once briefly adopted statutory provisions that specifically would have permitted a taxpayer to deduct anticipated expenses by a reserve mechanism is hardly significant." *United States v. Hughes Properties, Inc.*, 476 U.S. 593, 604 n.4 (1986).

²⁰³ *Buckeye Int'l, Inc. v. Comm'r*, 49 T.C.M. (CCH) 376, 385 (1984).

²⁰⁴ See *Geyer, Cornell & Newell, Inc. v. Comm'r*, 6 T.C. 96, 100 (1946), cited in Brief for the United States at 16 n.2, *United States v. General Dynamics Corp.*, 107 S. Ct. 1732 (1987) (No. 85-1385).

barring a contest of the liability, the all events test has been satisfied.²⁰⁵ Deductibility does not turn on terminology.²⁰⁶

It would have been helpful if the Court in *General Dynamics* had put to rest the reserves issue by unequivocally repudiating the government's broad language. Although the Court did not do so, there should be no misunderstanding about its conclusion: if GD had established the portion of the claimed deduction representing additions to cover a "firmly established" liability (the claims already filed by the end of 1972), it would have been able to deduct that portion, whether represented in a "reserve" or not.²⁰⁷ That

²⁰⁵ The example also assumes that no other statutory provision requires deferral of the deduction.

²⁰⁶ *Buckeye Int'l, Inc. v. Comm'r*, 49 T.C.M. (CCH) 376, 385 (1984) ("Where . . . the liability in question satisfies both requirements of the all events test, accrual is proper despite the label used by [the Internal Revenue Service]").

²⁰⁷ *General Dynamics Corp.*, 107 S. Ct. at 1737. The Court concluded that "[b]ecause the taxpayer failed to demonstrate that any of the deducted reserve represented claims for which its liability was firmly established as of the close of 1972, all the events necessary to establish liability were not shown to have occurred, and therefore no deduction was permissible." *Id.*

The Court thus implicitly rejected the government's argument that the repeal of I.R.C. § 462 had special significance for the self-insurance reserves at issue in *General Dynamics*. The legislative history of I.R.C. § 462 included in the examples of deductible items estimates of "certain liabilities for self-insured injury and damage claims." H.R. REP. NO. 1337, 83d Cong., 2d Sess. A163 (1954), *reprinted in* 1954 U.S. CODE CONG. & ADMIN. NEWS 4017, 4301 [hereinafter 1954 House Report, with page citations to USCCAN]; S. REP. NO. 1622, 83d Cong., 2d Sess. 63, 305-07 (1954), *reprinted in* 1954 U.S. CODE CONG. & ADMIN. NEWS 4621, 4946 [hereinafter 1954 Senate Report, with page citations to USCCAN]. In *General Dynamics*, the government argued that these passages in the committee reports evidenced

Congress's view . . . that reserves for estimated expenses could not have been accrued by ordinary taxpayers before the enactment of Section 462, and the calculated repeal of that Section was "a mandate from the Congress" that an accounting method entailing such reserves "was not acceptable for tax purposes."

Brief for the United States at 28, *General Dynamics* (No. 85-1385).

But all that is inferable from the legislative history is that, before the enactment of I.R.C. § 462, there were some expenses associated with self-insured injury claims that were not deductible before payment. The committee reports did not separate those items deductible only because of I.R.C. § 462 from those items that would have been deductible without regard to the section. That separation should have required application of the all events test. *Cf.* 1954 House Report, *supra*, at 4074 (describing law before enactment of, and therefore presumably after retroactive repeal of, I.R.C. § 462); 1954 Senate Report, *supra*, at 4695 (to

was the law prior to *General Dynamics*. If it is not the law today, it is because section 404 applies to such a situation,²⁰⁸ not because the taxpayer employs a reserve method of accounting.

CONCLUSION

[W]hile it is proper that people should find fault when their judges fail, it is only reasonable that they should recognize the difficulties. Perhaps it is also fair to ask that before the judges are blamed they shall be given the credit of having tried to do their best. Let them be severely brought to book, when they go wrong, but by those who will take the trouble to understand.—Learned Hand²⁰⁹

The Supreme Court has heard many cases on the timing of deductions, and in the last two terms the Court inexplicably decided two more. Because of the changes made by the Tax Reform Act of 1984, it is tempting to see *Hughes Properties* and *General Dynamics* simply as wasted effort. Even the surviving principles of the all events test will have to be reevaluated in subsequent cases in light of the economic performance requirement and other new statutory provisions.

But characterizing the Court's written products as wasted effort is too generous. In these two cases, the Court confused the application of the unmodified all events test, misled taxpayers about the

same effect).

For example, I.R.C. § 462, had it remained in effect, may have permitted the deduction of additions to reserves reflecting injuries incurred without regard to whether medical services had actually been provided in that same taxable year. Certainly such an understanding is consistent with the cursory references unearthed by the government in the legislative history. Without I.R.C. § 462, the all events test would have treated the provision of medical care as a necessary "event" and would have denied a deduction at least until such care had been provided. The treatment of such reserves was irrelevant to GD's situation, however, because GD took no deductions with respect to medical services to be provided in the future. Cf. Crane, *supra* note 36, at 282 (*General Dynamics* different from most "self-insurance" cases in that there was no attempt to estimate liabilities arising from indeterminate facts that would occur only in future years).

²⁰⁸ See *supra* notes 136-60 and accompanying text.

²⁰⁹ L. HAND, *How Far is a Judge Free in Rendering a Decision?*, in *THE SPIRIT OF LIBERTY* 110 (3d ed. 1960).

analysis of employee benefit liabilities required by the Tax Reform Act of 1984, and applied ill-conceived methods of statutory construction. It is difficult, particularly with the opinion in *General Dynamics*, to discern any effort at all.

The Justices obviously do not view working on a tax case as a pleasant way to spend a winter's day. Few people do. But the Court did not have to decide *Hughes Properties* and *General Dynamics*. It can pick the tax cases it hears, and in these cases strong substantive reasons existed not to grant certiorari. As sympathetic as we might be to the Court's lack of enthusiasm, once it decides to proceed with a case, we may reasonably expect a serious effort. Although Judge Hand's admonition is eminently fair as a general matter, we would show the members of this Supreme Court little respect if we were to conclude that, in *Hughes Properties* and *General Dynamics*, they had done their best.